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A number of years ago, one of the nation's leading authorities on securities law wrote an article for the ABA's *Forum* which warned of the increasing exposure of financial institutions to liability under the federal securities laws.[1] The accuracy of Professor David Ruder's predictions has been illustrated in a number of recent securities fraud cases involving staggering sums of money.[2] Modern securities fraud actions tend to involve an ever increasing number of defendants, many of whom had only a peripheral connection with the primary wrongdoers, but who may nevertheless be jointly liable under the expanding scope of the federal securities laws. The expansion of such liability has resulted to a large degree from the supplementation of the federal statutes by common law principles of derivative liability, a trend which

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1. Ruder, *Increasing Danger of Loss for Financial Institutions Under the Federal Securities Laws*, 8 FORUM 323 (1972).

2. Perhaps the most publicized example is the litigation resulting from the collapse of the U.S. Financial real estate empire, in which nearly 100 defendants, including a number of major banks, were sued for several hundred million dollars. *See In Re* U.S. Financial Sec. Litigation, 75 F.R.D. 702 (S.D. Ca. 1977). The settlements in this case have exceeded those in any previous securities litigation. The contribution of one of the defendant banks, together with its legal fees and disbursements, exceeded $25 million.

owes no small part of its impetus to the commentaries of Professor Ruder.[3]

Many defendants in securities fraud actions can be expected to look to their insurance carriers for protection from the enormous expense of defending such an action and from any resulting liability. This article deals with the insurability of losses resulting from liability under the federal securities laws. Although it will focus primarily on fidelity bond coverage for such losses, its analysis is not restricted to any particular type of indemnity bond or policy, and the conclusions reached would be applicable to any contract of indemnification against loss or liability. Owing to the scarcity of case law in this area, the discussion will be based largely on analogous authority. On the basis of this authority, the article will conclude that it is against public policy in certain circumstances to permit indemnification for a loss arising from liability for a violation of federal securities laws.

SECONDARY LIABILITY UNDER THE SECURITIES LAWS

The most familiar provision of the federal securities laws is Rule 10b-5,[4] promulgated by the Securities Exchange Commission (hereinafter referred to as S.E.C.) pursuant to the authority of section 10b of the Securities Exchange Act of 1934.[5] Section 10b prohibits the use of any "device, scheme or artifice to defraud" in connection with the purchase or sale of securities.[6] Rule 10b-5 is an umbrella provision which covers most of the activities prohibited elsewhere in the 1934 Act, as well as many which are not included within the ambit of the much narrower Securities Act of 1933.[7] An analysis of the types of activities which can constitute a violation of the federal securities laws is beyond the scope of this article.[8] This article will focus on the elements necessary to establish secondary liability for such violations. Secondary liability, as distinguished from primary liability, may be defined as liability which is vicarious or derivative, and results either from a special relationship with one primarily liable or from the tangential degree of participation in the violation.

3. *See* Ruder, *Multiple Defendants in Securities Law Fraud Cases: Aiding and Abetting, Conspiracy,* In Pari Delicto, *Indemnification and Contribution*, 120 U. PA. L. REV. 597 (1972), which has been quoted and relied upon in numerous decisions.
4. 17 C.F.R. § 240.10b-5 (1981).
5. 15 U.S.C. §78b (1976 & Supp. IV 1980).
6. 17 C.F.R. §240.10b-5(a) (1981).
7. *See* 15 U.S.C. §§77a-77aa (1976 & Supp. IV 1980).
8. This subject is covered in *Affiliated Ute Citizens v. U.S.*, 406 U.S. 128 (1972) and *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833 (2d Cir. 1968). *See generally* A. BROMBERG, SECURITIES LAW (1977).

A. The Inclusive Position

The particular type of secondary defendant with whom this article is primarily concerned is an employer (including a corporation or other business enterprise), which is sought to be held vicariously liable for a securities violation committed by an officer, employee or agent. Under familiar principles of agency law, the plaintiff has essentially two alternative theories for establishing the liability of the employer. The first theory, based upon the doctrine of *respondeat superior*, imposes absolute liability on an employer for the torts committed by his employee within the scope of his employment.[9] A closely analogous rule imposes liability on a principal for the torts of his agent committed within the scope of the agency. The second theory of recovery is based upon the doctrine of apparent (or ostensible) authority, which imposes absolute liability based upon the principal's manifestation to third persons as to the agent's authority to act for the principal in the transaction.[10] Both of these legal theories impose liability upon the employer without regard to the employer's own fault or culpable participation. The view that these twin common law principles of vicarious liability are to be incorporated into the framework of the federal securities laws is sometimes referred to as the "inclusive" position.

B. The Exclusive Position

In recent years, a number of courts have squarely rejected the inclusive position, and have held that an employer or principal cannot be held liable for the violation of the antifraud provisions of the federal securities laws by an employee or agent unless the employer or principal was a *knowing and culpable participant* in the fraud.[11] These courts have concluded, on the basis of the legislative history of the 1933 and 1934 Acts, that Congress intended to exclude common law rules of vicarious liability which impose liability without regard to fault.[12] This position, known as the "exclusive" viewpoint, is based upon the "controlling persons" provisions of the Acts. Section 20(a) of the 1934 Act imposes liability upon every person who exercises control over a violator "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."[13]

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9. Holloway v. Howerdd, 536 F.2d 690, 694-95 (6th Cir. 1976).
10. Johns Hopkins Univ. v. Hutton, 422 F.2d 1124 (4th Cir. 1970).
11. *See, e.g.*, Rochez Brothers, Inc. v. Rhoades, 527 F.2d 880, 885 (3d Cir. 1975); Zweig v. Hearst Corp., 521 F.2d 1129, 1132 (9th Cir. 1975), *cert. den.*, 423 U.S. 1025 (1975); Lanza v. Drexel & Co., 479 F.2d 1277, 1289 (2d Cir. 1973).
12. *See* 479 F.2d at 1299; 527 F.2d at 884-85.
13. 15 U.S.C. §78t (1976 & Supp. IV 1980). The controlling persons provision of the 1933

The distinction between the absolute liability under agency law and liability under Section 20(a) is that, under the latter, the controlling person has a "good faith" defense. The courts which adhere to the exclusive viewpoint hold that the controlling persons provisions are the exclusive method of imposing liability upon an employer for the securities violations of an employee.[14]

C. The Requirement of "Culpable Participation"

A controlling person is any person or entity who exercises a direct means of discipline or influence short of actual direction over the violator.[15] An employer or corporation will uniformly be held to be a controlling person with respect to an employee or officer except in those rare instances in which the officer or director occupies such a position of ownership or power as to be the controller of the corporation. However, because of the existence of the good faith defense of Section 20(a), a controlling person is not liable unless he was guilty of "culpable participation" in the fraud.[16] In *Rochez Brothers, Inc. v. Rhoades*,[17] for example, Rhoades, an officer-director of defendant M.S. & R. Corporation, was alleged to have committed a Rule 10b-5 violation in failing to disclose material information in connection with a purchase of the corporation's stock from plaintiff. In holding M.S.&R. was not liable for the conduct of Rhoades, the Third Circuit stated:

> The legislative history of Section 20(a) illustrates that Congress intended liability to be based on something besides control. That something is culpable participation.[18]
>
> . . . .
>
> We hold . . . that secondary liability cannot be found under §20(a)

Act (Section 15, 15 U.S.C. §77o) exonerates a controlling person if he "had no knowledge of or reasonable ground to believe in the existence of the facts . . ." constituting the violation of the controlled person. There is very little case law dealing with Section 15, because most plaintiffs prefer to proceed under the more sweeping 1934 Act. The prevailing view appears to be that Section 15 is to be interpreted similarly to Section 20a. Jackson v. Bache & Co., Inc., 381 F. Supp. 71, 94 n.12 (N.D. Ca. 1974) (stating that the two provisions are "treated identically"). Yet Section 15 has also been interpreted as imposing only a standard of reasonable care, at least where the primary violation requires only negligence. DeMarco v. Edens, 390 F.2d 836, 841-42 (2d Cir. 1968). The following analysis is based on Section 20a, and although it is believed to be applicable to Section 15 as well, the foregoing reservations should be kept in mind.

14. The legislative history of the controlling persons provisions which forms the basis of the inclusive-exclusive schism is too complex to permit a meaningful discussion in this article. *See generally* Comment, *The Burden of Control: Derivative Liability Under Section 20(a) of the Securities Exchange Act of 1934*, 48 N.Y.U. L. REV. 1019 (1973); Comment, *The Controlling Persons Provisions: Conduits of Secondary Liability Under Federal Securities Laws*, 19 VILL. L. REV. 621 (1974); Comment, *Vicarious Liability for Securities Law Violations: Respondeat Superior and the Controlling Persons Sections*, 15 WM. & MARY L. REV. 713 (1974).

15. *See* SEC v. Management Dynamics, Inc., 515 F.2d 801, 812 (2d Cir. 1975).

16. Lanza v. Drexel & Co., 479 F.2d 1277, 1299 (2d Cir. 1973). This decision coined the phrase "culpable participation."

17. 527 F.2d 880 (3d Cir. 1975).

18. *Id.* at 884-85.

> unless it can be shown that the defendant was a culpable participant in the fraud. Liability may be established whether the secondary defendant was directly or indirectly involved in the fraud . . . and may be premised on inaction, but only if it is apparent that the inaction intentionally furthered the fraud or prevented its discovery . . . . Inaction alone cannot be a basis for liability. We found that M.S.&R. had no knowledge of Rhoades' fraudulent acts and did not 'consciously intend' to aid Rhoades in his fraudulent scheme. The appellant would have been required to show that the defendant's inaction was deliberate and done intentionally to further the fraud.[19]

In *Zweig v. Hearst Corp.*,[20] Campbell, a financial columnist and employee of Hearst Corporation, wrote an article which was published in a Hearst newspaper. The article touted the stock of a certain corporation but failed to disclose that Campbell had recently purchased stock in that corporation. Immediately after publication of the article, the stock rose dramatically, Campbell sold his holdings, and the stock then declined. Plaintiffs, shareholders of a corporation merging with the company whose stock was touted, sued Campbell and Hearst under the Rule 10b-5.

The District Court granted Hearst's motion for summary judgment, and the Ninth Circuit affirmed.[21] It observed that Section 20(a) was the exclusive method of imposing liability upon Hearst and rejected the argument that such liability could be based on principles of agency law or on the failure of Hearst to adequately supervise Campbell.[22] The court stated:

> Some lesser standard amounting more nearly to culpability is indicated. A newspaper which requires its reporters to report facts fairly and accurately has a right initially to expect compliance. Unless somehow placed on notice that a particular writer has violated or may violate the requirement of fairness and accuracy, the newspaper may continue to safely anticipate compliance.[23]

A number of the exclusive courts have recognized an exception to the requirement of culpable participation where the secondary defendant is a securities broker or dealer. In order to satisfy the requirement of good faith, it is necessary for a broker-dealer to show that precautionary measures were taken to prevent the violation, and that adequate supervision was maintained over the violating employee.[24] This test,

19. *Id.* at 890 (citations omitted).
20. 521 F.2d 1129 (9th Cir.), *cert. den.*, 423 U.S. 1025 (1975).
21. *Id.* at 1136.
22. *Id.* at 1132.
23. *Id.* at 1135. *See also* Zweig v. Hearst, 54 N.C. L. REV. 488 (1976).
24. Marbury Management, Inc. v. Kohn, 629 F.2d 705, 716 (2d Cir. 1980). The Ninth Circuit, however, recently rejected this view, holding that a brokerage firm is not liable for its em-

frequently referred to as the "broker-dealer precautionary-supervisory standard," is essentially a negligence standard, and its applicability turns solely on the distinction between brokerage firms and other types of business enterprises. According to the exclusive viewpoint, however, businesses other than broker-dealers have no duty to institute precautionary measures or to supervise their officers or employees to prevent securities fraud.

Although the Supreme Court has been afforded a number of opportunities to resolve the inclusive-exclusive split, it has chosen not to do so. At the present time, the inclusive position has been adopted by the Fourth Circuit,[25] the Fifth Circuit,[26] the Sixth Circuit[27] and the Seventh Circuit.[28] It has also been advocated by the S.E.C. in administrative rulings.[29] The exclusive position has been adopted by the Second Circuit,[30] the Third Circuit,[31] the Ninth Circuit,[32] and arguably also the Eighth Circuit.[33] No definitive position has been taken by the First or Tenth Circuits.

The courts which have adopted the exclusive viewpoint, however, clearly enjoy the more prestigious reputation in the area of federal securities laws. The Second, Third and Ninth Circuits have decided the great majority of securities fraud cases, probably owing to their proximity to the nation's major securities exchange centers, and have long been regarded as the pioneers in this area of the law. Their position should accordingly carry considerable weight when this issue comes before the U.S. Supreme Court.

THE STANDARD OF CULPABILITY OF A CONTROLLING PERSON

No precise definition of the term "culpable participation" has been formulated by the courts. However, it appears that a plaintiff seeking to overcome the good faith defense of Section 20(a) must demonstrate that the controlling person had knowledge of the fraud of the con-

ployee's securities fraud unles the firm was a "culpable participant." Christoffel v. E. F. Hutton & Co., Inc., 588 F.2d 665, 668 (9th Cir. 1978).

25. Johns Hopkins Univ. v. Hutton, 422 F.2d 1124 (4th Cir. 1970).
26. Lewis v. Walston & Co., Inc., 487 F.2d 617 (5th Cir. 1973).
27. Armstrong, Jones & Co. v. S.E.C., 421 F.2d 359 (6th Cir.), *cert. den.*, 398 U.S. 958 (1970).
28. Fey v. Walston & Co., Inc., 493 F.2d 1036 (7th Cir., 1974).
29. Cady, Robertson & Co., 40 S.E.C. 907 (1961).
30. Lanza v. Drexel & Co., 479 F.2d 1277, 1299 (2d Cir. 1973). The Second Circuit has permitted the use of agency law in S.E.C. enforcement proceedings, though. S.E.C. v. Management Dynamics, Inc., 515 F.2d 801, 812 (2d Cir. 1975).
31. Rochez Brothers, Inc. v. Rhoades 527 F.2d 880, 884-85 (3d Cir. 1975). The Third Circuit has approved the use of agency law in the context of broker-dealers, but has rejected such an argument with regard to other business entities. Thomas v. Duralite Co., Inc., 524 F.2d 577, 586 n.4 (3d Cir. 1970).
32. Zweig v. Hearst Corp., 521 F.2d 1129, 1132 (9th Cir.), *cert. den.*, 423 U.S. 1025 (1975).
33. Myzel v. Fields, 386 F.2d 718, 738 (8th Cir. 1967).

trolled person and was guilty of affirmative conduct or inaction which substantially facilitated the commission of the violation.

There existed for many years a split among the courts as to whether a violation of Section 10b and Rule 10b-5 could be based upon mere negligence or whether the plaintiff was required to prove scienter. In the landmark decision of *Ernst & Ernst v. Hochfelder*,[34] the Supreme Court held that such a violation can be based only on a finding of scienter, which it defined as "intent to deceive, manipulate, or defraud."[35] The Court observed that various provisions of the federal securities laws predicate liability on various states-of-mind which fall into three categories: intentional, negligent and innocent. The Court based its holding in part upon a number of analogous provisions of the 1934 Act which it concluded demonstrate a requirement of intent to defraud. One of these provisions was Section 20(a). The Second and Third Circuits, which had advocated a scienter requirement for liability under Section 10b and Rule 10b-5 even prior to *Hochfelder*, have also concluded that the standard of culpability under these provisions should be included in Section 20(a).[36] A leading commentator has suggested that *Hochfelder* by implication requires such an interpretation of Section 20(a).[37]

The requirement of culpable participation has also been analogized to the common law doctrine of aiding and abetting. The court in *Rochez Brothers, Inc. v. Rhoades* pointed out that this doctrine is an alternative method of imposing liability on an employer for the violations of an employee. The elements of aiding and abetting are: (1) an independent violation by a third party; (2) knowledge of the violation by the defendant; (3) knowing and substantial assistance and participation by the defendant in the violation.[38] In the context of an employment relationship, the evidence necessary to establish aiding and abetting has been stated to be the same as that necessary to overcome the good faith defense under Section 20(a).[39]

Although the Supreme Court in *Hochfelder* declined to consider

34. 425 U.S. 185 (1976).

35. *Id.* at 193.

36. 479 F.2d at 1305-06; 527 F.2d at 888-89.

37. *See generally* Cox, *Ernst & Ernst v. Hochfelder*, 28 HASTINGS L.J. 569 (1977). *See also* Comment, *The Controlling Persons Liability of Broker-Dealers*, 1974 DUKE L.J. 824, 842 (1974), stating that a finding of bad faith under Section 20(a) requires scienter, and that the only difference between the scienter requirement under Rule 10b-5 and the good faith defense is a shift in the burden of proof from the plaintiff to the defendant seeking to establish the defense. *Accord*, Gould v. American-Hawaiian S.S. Co., 351 F. Supp. 853 (D. Del. 1972).

38. See note 17 *supra*. *See also* Monsen v. Consolidated Dressed Beef Co., Inc., 579 F.2d 793 (3d Cir. 1978).

39. *See* Gould v. American-Hawaiian S.S. Co., 535 F.2d 761, 779 (3d Cir. 1976) (not an appeal from the case cited at note 37 *supra*).

whether reckless conduct is sufficient to satisfy the scienter requirement, numerous prior and subsequent decisions have recognized the sufficiency of recklessness to establish a violation.[40] However, the prevailing view is that the finding of recklessness is not in itself equivalent to scienter, but rather merely evidence from which the factfinder can infer scienter. As stated in *Woodward v. Metro Bank of Dallas*,[41] "Knowledge may be shown by circumstantial evidence or by reckless conduct, but the proof must demonstrate actual awareness of the party's role in the fraudulent scheme."[42]

The standard of culpability necessary to overcome the good faith defense of a controlling person has nothing to do with the schism between the inclusive and exclusive courts, though. The inclusive courts as well as the uncommitted courts which have analyzed Section 20(a) have interpreted the good faith defense consistently with the exclusive courts.[43] The distinction between the inclusive and exclusive positions is simply that, under the former view, an employer cannot escape liability merely by establishing his good faith, but must also negate his liability under the principles of agency law.

To briefly summarize, then, an employer — whether an individual, partnership, corporation or other business entity, other than a securities broker — is not liable for the federal securities violations of an employee in the courts following the exclusive position unless the employer was a culpable participant in the fraud. In order to be a culpable participant, he must have had knowledge of the fraud and rendered substantial assistance in its perpetration. The question which now arises is whether a loss resulting from such liability is compensable under a fidelity bond, or other form of indemnity insurance.

INSURANCE COVERAGE FOR INTENTIONAL ACTS OF INSURED

A broad form fidelity bond generally insures against loss to the insured caused by employee fraud or dishonesty, and has been interpreted as providing coverage for a loss sustained by reason of the liability of the insured to a third party arising from employee fraud.[44]

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40. *See* Nelson v. Serwold, 576 F.2d 1333, 1337 (9th Cir. 1978); 479 F.2d at 1306.
41. 522 F.2d 84 (5th Cir. 1975).
42. *Id.* at 96, citing A. BROMBERG, SECURITIES LAW: *Fraud* §85(582) (1974)).
43. *See* SEC v. First Sec. Co., 463 F.2d 981 (7th Cir.), *cert. den.*, 409 U.S. 880 (1972); Richardson v. McArthur, 451 F.2d 35, 42 (10th Cir. 1975).
44. *See generally* Jefferson Bank & Trust Co. v. Central Sur. & Ins. Corp., 408 S.W.2d 825 (Mo. 1966). In 1976, the definition of fraud and dishonesty in the Form 24 Bankers Blanket Bond was modified. Coverage is now provided only where the employee acted with the manifest intent to cause the loss to the insured, *or* to obtain a financial benefit for himself or another. This new provision should not provide a defense to the insurer in a significant percentage of cases in which the insured is held liable to a third party.

It also appears to be settled, though, that such a loss is covered only if the liability of the insured is vicarious, that is, based upon principles of agency law which impose absolute liability without regard to fault. In *Levey v. Jamison*,[45] one of the most well-known fidelity bond cases dealing with what may be referred to as a "corporate act" defense, the court remanded the case for further evidence as to whether the alleged embezzler acted with the knowledge and assistance of other high-level officers of the corporation, stating:

> It is manifest if the jury should find that the corporation itself was a party to the acts complained of, there can be no recovery in this case. The parties to the bond did not mean to insure the corporation against losses which might be caused by its own dishonesty or crime, but merely to protect it against the dishonesty or crime of its employees. A policy of fidelity insurance does not insure an employer against its own fraud.[46]

No attempt will be made in this article to analyze the numerous cases dealing with this defense. A considerable discussion of these cases appears in Montgomery, *The Alter Ego Type Defenses Reconsidered*.[47] A comparison of the factual setting of the cases discussed in the above article will reveal, upon close analysis, that the very conduct on the part of the insured necessary to render it liable under the controlling persons provisions of the federal securities laws will operate to prohibit recovery under a fidelity bond or other indemnity insurance agreement.

The majority of the federal securities fraud cases in which liability has been imposed on a corporation under controlling persons provisions have involved one or more wrongdoers who were either high-level officers or directors whose acts by virtue of their domination of the corporation were considered to be the acts of the corporation itself and thus sufficient to defeat the good faith defense.[48] Other cases have involved violations by an ordinary employee or agent which were committed with the knowledge of high-level officers of the corporation.[49] Compare these cases to fidelity bond cases in which recovery was denied on the basis of the insured's participation in the fraud: *West American Finance Co. v. Pacific Indemnity Co.*,[50] where the wrongful acts were committed by the controlling officers and directors; or *First*

45. 82 F.2d 958 (4th Cir. 1936).

46. *Id.* at 960. *See also* First National Bank v. Transamerica Ins. Co., 514 F.2d 981 (8th Cir. 1975); Phoenix Savings & Loan, Inc. v. Aetna Cas. & Sur. Co., 427 F.2d 862 (4th Cir. 1970).

47. 13 FORUM 528 (1979). *See also* Skillern, *When Dishonesty by Officers of Insured Becomes Dishonesty of Insured to Preclude Recovery Under Fidelity Bond*, 5 FORUM 235 (1970).

48. *See, e.g.*, SEC v. Geon Indus., Inc., 531 F.2d 39 (2d Cir. 1976); S.E.C. v. Lum's, Inc., 365 F. Supp. 1046 (S.D.N.Y. 1973) (acts of wrongdoers considered "corporate acts"); *cf.* Reeder v. Mastercraft Electronics Corp., 363 F. Supp. 574 (S.D.N.Y. 1973).

49. *See* Richardson v. McArthur, 451 F.2d 35, 41-42 (10th Cir. 1971).

50. 17 Cal. App. 2d 225, 61 P.2d 963 (1936).

National Bank of Sikeston v. Transamerica Ins. Co.[51] where various high-level officers silently condoned the president's check-floating scheme. Compare the analysis of the imputed knowledge doctrine in the fidelity bond case of *Phoenix Savings & Loan Inc. v. Aetna Casualty & Surety Co.*[52] with that of the securities fraud case of *Gould v. American Hawaiian S.S. Co.*[53] The legal principles upon which the courts have relied to *impose* liability under Section 20(a) are the same as those which have long been the basis for *denying* indemnity under fidelity or indemnity insurance coverage.

It is the thesis of this article that a loss resulting from liability under the federal securities law should not be and is not compensable *under any circumstances* if the insured was held liable in a court following the exclusive viewpoint.[54] The mere fact of such liability should estop the insured in the subsequent action against the insurer from relitigating the issue whether the insured knowingly participated in the fraud.[55] If, on the other hand, the insured was held liable in an inclusive forum,[56] the subsequent liability of the insurer should depend upon whether the insured's liability was based on principles of common law vicarious liability or upon a controlling persons provision. If the insured's liability was based upon both concepts, or upon the controlling person provision alone, the loss should not be compensable. If the insured settled the third-party action prior to a final judgment the loss should not be compensable if the litigation occurred in an exclusive forum and the legal theory for recovery advanced was a federal securities act violation.

Indemnification and Public Policy

Analogous authority for this position may be found in decisions holding that an agreement of indemnity which purports to indemnify a corporation for a willful violation of the securities laws is void as against public policy. For this purpose, three leading decisions will be analyzed.

51. 514 F.2d 981 (8th Cir. 1975).
52. 427 F.2d 862 (4th Cir. 1970).
53. 535 F.2d 761 (3d Cir. 1976).
54. See text accompanying notes 10-13 *supra*.
55. The use of defensive collateral estoppel by a stranger to the prior action is well established. *See* Blonder-Tongue Lab., Inc. v. University of Illinois Foundation, 402 U.S. 313, 326 (1970).
56. See text accompanying notes 8-9 *supra*.

A. Globus v. Law Research Service, Inc.

In *Globus v. Law Research Service, Inc.*,[57] a corporate underwriter was held liable to a third party under provisions of both the 1933 and 1934 Acts. Such liability was necessarily based upon knowledge of misrepresentations made by its codefendant, the corporate issuer, in the offering circular. The underwriter sought indemnification from this codefendant under the terms of an express indemnity agreement. The District Court refused to allow indemnity, stating:

> It would be against the public policy embodied in the federal securities legislation to permit [the underwriter], which has been found guilty of misconduct in violation of the public interest involving actual knowledge of false and misleading statements or omissions and wanton indifference to its obligations and the rights of others, to enforce its indemnification agreement.
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> . . . .
>
> If an underwriter were to be permitted to escape liability for its own misconduct by obtaining indemnity from the issuers, it would have less of an incentive to conduct a thorough investigation and to be truthful in the prospectus distributed under its name, than it would have if the indemnity was unenforceable under such circumstances.[58]

The Second Circuit, in affirming the holding, approved of this reasoning and added the following remarks:

> [I]t is important to emphasize at the outset that at this time we consider only the case where the underwriter has committed a sin graver than ordinary negligence.
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> . . . .
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> [T]o tolerate indemnity under these circumstances would encourage flouting the policy of the common law and the Securities Act. It is well established that one cannot insure himself against his own reckless, willful or criminal misconduct.[59]

The decision in *Globus* was based in part upon the position of the Securities Exchange Commission that indemnification of directors, officers and controlling persons against liability arising under the 1933 Act is against public policy.

Although *Globus* provides strong support for the position suggested in this article, it is technically distinguishable from a case in which the liability of the insured was based on a controlling persons provision. *Globus* was decided prior to the time the inclusive-exclusive schism de-

57. 287 F. Supp. 188 (S.D.N.Y. 1968), *aff'd in part and rev'd in part*, 418 F.2d 1276 (2d Cir. 1969), *cert. den.*, 397 U.S. 913 (1970).
58. 287 F. Supp. at 199. Compare this language with that of the Supreme Court in *Hochfelder*, 425 U.S. at 209 n.28, which stated that Section 20(a) "contains a state-of-mind condition requiring something more than negligence."
59. Globus v. Law Research Serv., Inc., 418 F.2d 1276, 1288 (2d Cir. 1969).

veloped, and neither of the opinions in the case discussed the conceptual basis of the liability of the underwriter, stating merely that the corporation had knowledge of the fraud of its president. Although it appears clear that the corporation would have been liable under Section 20(a), the opinions did not mention this provision.

B. DeHaas v. Empire Petroleum Co.

Another leading decision in this area is *DeHaas v. Empire Petroleum Co.*,[60] which illustrates the distinction between permitting indemnity where liability is merely vicarious and permitting it where liability is based upon fault. Empire Corporation and its controlling stockholder-director, Stone, were sued for a Rule 10b-5 violation. Both defendants cross-complained against a third party seeking indemnification in the event they were held liable. The District Court dismissed Stone's cross-complaint because any finding of liability on the part of Stone would necessarily require a finding that he "knowingly participated in the fraud." The court refused to dismiss Empire's cross-complaint, reasoning that Empire's liability, if any, would be based only on principles of agency law rather than knowing participation.[61] These rulings were not contested in the subsequent appeal.

The reasoning in *DeHaas* is precisely why the defense suggested in this article might fail if the liability of the insured were established in a forum following the inclusive position (unless, of course, liability was also predicated on a controlling persons provision). In an exclusive court, on the other hand, in which agency principles are unavailable to impose secondary liability, indemnification should be disallowed because the liability of the indemnitee, like that of Stone, would necessarily be based on knowing participation in the fraud.

C. Seiffer v. Topsy's Intern., Inc.

However, a federal district court considering the same question posed in *DeHaas* reached a contrary conclusion. In *Seiffer v. Topsy's Intern., Inc.*,[62] a class action was brought against a corporate issuer, Topsy's, together with three of its high-level officers and its accounting firm. The action, brought under Section 10b and Rule 10b-5, was based upon alleged nondisclosures by the corporation and its accountants in connection with a prior corporate acquisition. Topsy's and its officers settled with the plaintiffs and brought an action for implied and

60. 435 F.2d 1223 (10th Cir. 1970).
61. *See* DeHaas v. Empire Petroleum Co., 286 F. Supp. 809, 815 (D. Colo. 1968).
62. 487 F. Supp. 653 (D. Kan. 1980).

express indemnity against the accounting firm to recover the amount of the settlements and defense costs. The court, relying on *Globus*, denied indemnity, stating:

> Plaintiffs' claims, which Topsy's [and its officers] settled, were for fraud; the attorneys' fees expended were in defense of allegations of fraud. The anti-fraud provisions of the 1934 Act, which served as the basis of plaintiffs' claims against these defendants, require misconduct more serious than negligence, that is, recklessness or willful misconduct. 'It is well established that one cannot insure himself against his own reckless, willful or criminal misconduct.' In the context of securities laws violations, an indemnification agreement would be unenforceable.[63]

Since *Seiffer* was decided by a court from within the Tenth Circuit, which still follows the inclusive viewpoint, Topsy's could have been held vicariously liable for the fraud of its officers and therefore should have been permitted to maintain an indemnity action under the reasoning of the Tenth Circuit decision in *DeHaas*. The significance of *Seiffer* is its suggestion that the public policies underlying the federal securities laws might supercede technical distinctions between primary and vicarious liability of the indemnitee. If so, indemnity might be prohibited in an inclusive as well as in an exclusive jurisdiction.

D. The Future of Indemnity Clauses After Globus

Globus has been followed in cases dealing with a variety of factual situations and different types of defendants.[64] The decision was highly praised by the commentators, a number of whom argued that *Globus* had not gone far enough. One observer predicted "that ultimately indemnity provisions, even as applied to cases of negligence rather than willful misconduct, will be held to be violative of public policy underlying [the federal securities] laws."[65]

This suggestion has been adopted by district courts from within the Second and Third Circuits. In *Gould v. American-Hawaiian Steamship Co.*,[66] the lower court held that even though the defendant was guilty of mere negligence in a violation of Section 14(a) of the 1933 Act, implied indemnity would be contrary to the policy of the securities laws,

63. *Id.* at 708.

64. *See, e.g.*, Heizer Corp. v. Ross, 601 F.2d 330 (7th Cir. 1979); Premier Corp. v. Economic Research Analysts, Inc., 578 F.2d 551 (4th Cir. 1978); McLean v. Alexander, 449 F. Supp. 1251 (D. Del. 1978); Odette v. Shearson, Hammil Co., Inc., 394 F. Supp. 946 (S.D.N.Y. 1975); Altman v. Liberty Equities Corp., 54 F.R.D. 620 (S.D.N.Y. 1972).

65. Kroll, *Some Reflections on Indemnification Provisions, Etc.*, 24 BUS. LAW. 681, 692 (1969); *accord*, Comment, *Indemnification of Underwriters and Section 11 of the Securities Act of 1933*, 72 YALE L.J. 406 (1962).

66. 387 F. Supp. 163 (D. Del. 1974), *vacated and remanded*, 535 F.2d 761 (3d Cir. 1976). The appellate court did not express a view on the indemnity issue.

regardless of whether the indemnitor was guilty of intentional fraud or bore a greater responsibility for the violation.[67] The court stated:

> [S]ection 14(a) reaches negligent as well as deliberately deceptive conduct, and the considerations governing indemnity thereunder are, accordingly somewhat different.
>
> It is well established that the purpose of Section 14(a) is regulatory, not compensatory. . . . Thus, the question of who pays the damages to the plaintiffs is of as great concern as the issue of whether the plaintiffs are to be compensated at all. To allow indemnity to those who have breached responsibilities squarely placed upon them by the statute would vitiate remedial purposes under §14(a). Only a realistic possibility of liability for damages will encourage due diligence by those who solicit proxies and will protect the interest of informed corporate suffrage.[68]

Gould was relied upon in *Odette v. Shearson, Hammil & Co.*,[69] in which a brokerage firm was sued under various provisions of the 1933 and 1934 Acts, and cross-complained against a bank for implied indemnity. Liability under most of the provisions required a finding of either actual knowledge of the misrepresentation or reckless disregard of their truth or falsity, but one provision, Section 12(2) of the 1933 Act, required only a finding of negligence. The court concluded that the public policy factors expressed in *Globus* should be broadly interpreted to prohibit indemnification for negligent as well as knowing misconduct, and expressly distinguished the case at bar from a situation in which a defendant was held vicariously liable without fault.[70]

E. Right of Contribution

The right of an intentional or negligent wrongdoer to obtain *contribution* (as opposed to *indemnification*)[71] from a joint tortfeasor is specifically recognized by both the 1933 and 1934 Acts.[72] The right to contribution under those circumstances which precludes indemnification has been stated to be a useful method of allocating the damages fairly among all the wrongdoers without absolving one at the expense of another, and is considered to be in furtherance of the deterrent purposes of the securities laws.[73]

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67. 387 F. Supp. at 167.
68. *Id.* at 167-68.
69. 394 F. Supp. 946 (S.D.N.Y. 1975).
70. *Id.* at 956-57.
71. *See* 4 B. WITKIN, SUMMARY OF CALIFORNIA LAW *Torts* §50 (8th ed. 1974).
72. This right may be found in Section 11(f) of the 1933 Act and Sections 9(e) and 18(b) of the 1934 Act. 15 U.S.C. §§77k(f), 78i(e), 78r(b) (1976 & Supp. IV 1980).
73. *See* McLean v. Alexander, 449 F. Supp. 1251, 1265-68 (D. Del. 1978).

CONCLUSION

The assertion of this defense by an insurer should not encounter the traditional tendency of the courts to provide coverage in doubtful situations or the reluctance of the courts to accept insurance company defenses based on the alleged participation of the insured in the fraud as illustrated in a number of well known cases.[74] It must be observed that in each of those cases, the defense involved *questions of fact* which could be and which were resolved in favor of coverage. The defense discussed in this article, on the other hand, is a purely legal defense, the viability of which should not depend in any way upon the underlying facts of the case. The insurer's defense asserts that, since the insured's liability could be based only upon the knowing and culpable conduct of the insured, coverage is excluded. The sole issue before the court is whether, as a matter of law, the culpability and participation necessary to render an employer liable under Section 20(a) is sufficient to preclude indemnification.

A strong argument can be made that the threshold level of culpability on the part of the insured necessary to preclude indemnification is significantly lower in the context of federal securities law than in the context of other types of fraud. For example, it is well settled that mere negligence of the insured in permitting employee fraud is no defense to the insurer.[75] Yet it has been held that negligence of an indemnitee will preclude indemnification where the negligence involved the violation of federal securities law, irrespective of the degree of knowledge or participation of the indemnitor.[76] These holdings, which are extensions of the *Globus* decision, are based upon the public policies underlying the federal securities laws. Reason dictates that similar holdings in cases seeking indemnity should also be based upon the principle that an insured cannot recover from its carrier for loss sustained because of its own wilful misconduct. It has frequently been stated that the primary purpose of this statutory scheme is deterrence, and that its remedial aspects, which are largely the product of expansive judicial interpretation, are of only secondary importance.[77]

The current judicial skepticism toward some insurance coverage defenses would thus come into direct conflict with the deterrent policies of the federal securities laws in the context of a suit seeking indemnity for

74. *See, e.g.*, FDIC v. Lott, 460 F.2d 82 (5th Cir. 1972); General Fin. Corp. v. Fidelity & Cas. Co., 439 F.2d 981 (8th Cir. 1971).
75. Arlington Trust Co., Inc. v. Hawkeye-Security Ins. Co., 301 F. Supp. 854, 858 (E.D. Va. 1969).
76. Odette v. Shearson, Hammill & Co. 394 F. Supp. 946, 954 (S.D.N.Y. 1975).
77. *See generally* Globus v. Law Research Service, Inc., 287 F. Supp. 188 (S.D.N.Y. 1968), *aff'd in part and rev'd in part*, 418 F.2d 1276 (2d Cir. 1969), *cert. den.*, 397 U.S. 913 (1970).

liability resulting from a violation of these laws. There should be no such skepticism and the deterrent policies should be acknowledged and given effect. The *Globus* line of decisions indicates that the policies underlying the securities laws would prevail where the liability of the insured to the third party was based on a degree of fault greater than mere negligence, and that such policies might also prevail even where such liability is based on negligence alone. It is clear that the liability of an employer (other than a broker-dealer), as an exclusive forum for a violation of Rule 10b-5 or any provision of the 1934 Act, must be based on a degree of fault greater than negligence. A loss resulting from such liability should not be compensable under any form of fidelity bond or indemnity insurance agreement. Sound arguments can be made that a similar result should obtain with respect to liability under the 1933 Act.[78] The ultimate resolution of the inclusive-exclusive split by the United States Supreme Court should determine whether any such employer can insure itself against a loss resulting from a federal securities law violation in any jurisdiction.

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78. See note 13 *supra*.