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BANK FINANCING OF HOSTILE ACQUISITIONS OF CORPORATE LOAN CUSTOMERS

A special relation of trust and confidence, and the duties attendant thereto, arises when a commercial bank conditions a loan upon access to confidential proprietary information of a prospective customer. A serious conflict may develop if the bank later finances a tender offer for the stock of this prior loan customer. In the context of a hostile takeover, a target corporation may seek to defend by barring the financing upon the ground that the bank has improperly employed this proprietary data in evaluating the propitiousness of financing the tender offer. Two recent cases have concluded that a bank should not be absolutely precluded from financing the takeover of a customer. This Note analyzes three theories which could support a finding of a bank's liability for breach of fiduciary duty. The liability analysis also includes a demonstration of the applicability of the anti-deception provisions of the federal securities laws, along with an analysis of a possible "Chinese wall" defense by the bank. Finally, the Note advocates the propriety of injunctive relief until such time as legislative enactments balance the rights and obligations of the parties.

INTRODUCTION

THE ACCEPTANCE of the hostile takeover as a legitimate method of corporate expansion has spawned the development of sophisticated acquisition tactics and a corollary evolution of target management defense strategies. If target management determines that a takeover is not in the best interests of the company, its initial objective will be to forestall the pending offer. This Note will focus on one of the many defensive devices available to management—an effort to restrict the offeror's means of financing the takeover.¹

Recently, litigation has tested the conflict of interest which appears to arise when a bank finances the hostile takeover of a target with which it has a pre-existing relationship. A major commercial bank which engages in tender offer financing is now confronted with a quandary when contemplating whether to participate in the takeover of one of its corporate borrowers. No statutory law directly regulates this practice, and the limited case law which has developed is conflicting.² Because of this void, target companies

1. See generally Herzel & Rosenberg, *Loans to Finance Tender Offers: The Bank's Legal Problems*, 96 BANKING L.J. 676 (1979); Steinbrink, *Management's Response to the Takeover Attempt*, 28 CASE W. RES. L. REV. 882 (1978).

2. In *Washington Steel Corp. v. TW Corp.*, 602 F.2d 594 (3d Cir. 1979), the only appellate court to address this issue directly noted that legislative concern is present and may soon result in some statutory direction.

[T]here is every reason to believe that Congress is aware of this issue and has

defending against a tender offer supported by a bank with which they have an established relationship may perceive this relationship as a starting point for their defense.

Both Chemical Bank and Continental Illinois National Bank and Trust Company have recently found themselves subject to litigation that questioned their roles in financing tender offers directed to loan customers: Chemical Bank in *Washington Steel v. TW Corp.*³ and Continental in *American Medicorp v. Continental Illinois Nat'l Bank & Trust Co.*⁴ These two controversies are the primary bases for the existing case law on the subject.

The two cases presented virtually identical factual settings which, stated in general terms, established a model for the discussion in this Note:

A major commercial bank established a lending relationship with a corporation⁵ which became the object of a hostile takeover by means of a cash tender offer. In the course of this lending relationship, the bank received a package of financial materials from the target-borrower. Much of the transmitted information, notably projections of future earnings and development plans prepared by the borrower, was confidential or nonpublic.⁶ After the creation of this lending arrangement between the bank and the target corporation, the bank agreed to participate in the financing of a tender offer for the shares of the target's stock by another corporation. The decision to participate in this financing was allegedly made in part on an evaluation of the target's financial picture through the use of the confidential or nonpublic information supplied to the bank by the target-borrower in connection with the unrelated prior

begun the difficult process of effecting a legislative solution. In addition, the Comptroller of the Currency has recently proposed a regulation for national banks which suggests ways of restricting the use of confidential information obtained from one client on behalf of another. See Proposed Treas. Reg. § 9.7(d), 42 Fed. Reg. 56,338 (1977). . . . The Board of Governors of the Federal Reserve System has adopted a similar statement for state member banks. See 43 Fed. Reg. 12,755 (1978). . . . These developments evince a concern at the national level with the issues raised by Washington.

Id. at 601.

3. 602 F.2d 594 (3d Cir. 1979).

4. 475 F. Supp. 5 (N.D. Ill. 1977).

5. Continental Bank and American Medicorp had arranged a \$12.3 million loan and were in the process of structuring an additional \$11.4 million agreement. Hearing Transcript at 48, *American Medicorp, Inc. v. Continental Ill. Nat'l Bank & Trust Co.*, 475 F. Supp. 5 (N.D. Ill. 1977). Chemical Bank and Washington Steel Corp. had an established lending relationship whereby Chemical agreed to lend an amount up to \$2.25 million as one of three banks participating in a total loan program of \$10 million. *Washington Steel Corp. v. TW Corp.*, 602 F.2d at 596.

6. See generally Brief of Appellee at 4-5, *Washington Steel Corp. v. TW Corp.*, 602 F.2d 594 (3d Cir. 1979).

loans.⁷ It was not claimed that the bank directly transferred any of the nonpublic information to the offeror. After the second lending relationship was established, a tender offer was made to the target's shareholders. Litigation was initiated before any shares were tendered in response to the offer.

The judicial response to this factual setting has been varied. Judge Simmons in the trial court opinion in *Washington Steel* held that, under these circumstances, a bank is an agent of its corporate borrower and has a duty not to act adversely to the interests of that borrower. Additionally, the bank has a duty to disclose all relevant facts pertaining to this "dual agency relationship" so that the target may make an informed choice regarding whether to continue the relationship.⁸

Judge Gibbons, writing for a unanimous court in the appellate decision in *Washington Steel*, reversed the findings of Judge Simmons and held that a bank is not precluded from financing a hostile takeover of its corporate customer. In dicta, the court suggested that a bank does not violate any duty to a borrower in connection with its decision to lend to a second customer.⁹ Judge Gibbons premised his notion that banks are not prohibited from using such confidential information on the policy that banks should be permitted to use all available information in evaluating a prospective loan customer.¹⁰

Judge McMillen's trial court opinion in *American Medicorp* reflects a different approach in holding that a bank is not totally precluded from financing a hostile tender offer for the shares of its corporate borrower.¹¹ Finding no improper use or dissemination of the confidential information received from the target, he concluded that so long as such information is not relied upon when deciding to finance a takeover, the bank is free to deal with any other borrower. Both Judge Gibbons and Judge McMillen grounded their holdings on the belief that the per se breach of fiduciary duty urged by the targets would unduly constrict bank

7. In *American Medicorp*, there was no allegation of misuse of the confidential information, 475 F. Supp. at 7. In *Washington Steel*, the court found no misuse of such information, 602 F.2d at 602.

8. Judge Simmons found an additional breach in Chemical Bank's "overtly and actively directing its employees to conceal" this relationship from the target, *Washington Steel Corp. v. TW Corp.*, 465 F. Supp. 1100, 1105 (W.D. Pa. 1979).

9. 602 F.2d at 603.

10. *Id.*

11. 475 F. Supp. at 8.

financing and the flow of commerce.¹²

These diverse judicial responses draw attention to the need for thorough analysis and, possibly, legislative action.¹³ Bankers are concerned about the potential for burdensome litigation and adverse publicity.¹⁴ As one commentator has described the banks' view of tender offer loans: "The institutional lender is essentially a civilian among combatants in a war zone. It makes no entrepreneurial profits from a takeover and essentially all it wants to do is get repaid its loan and not have the regular course of its business interrupted."¹⁵ In a letter to the Chairman of the House Committee on Banking, Finance and Urban Affairs, then Federal Reserve Board Chairman G. William Miller also expressed concern:

[Although] there are no Federal bank laws specifically regulating bank loans to facilitate corporate takeovers . . . the misuse of confidential information by a bank in a proposed corporate takeover could be viewed as an unsafe or unsound banking practice if such misuse exposed the bank to legal liability or damaged the bank's reputation, resulting in a loss of public confidence.¹⁶

For their part, practitioners involved in orchestrating acquisitions or in defending against them are more concerned with the strategic import of the state of the law. Time is a crucial element in a tender offer. Counsel for acquiring firms naturally resist the development of a new defense tactic by a target effectively precluding tender offer financing through the arrangement of a series of loans from major banks,¹⁷ or raising sufficient legal questions to obtain a preliminary injunction.¹⁸ Target corporations, on the

12. *Washington Steel Corp. v. TW Corp.*, 602 F.2d at 601; *American Medicorp v. Continental Ill. Nat'l Bank & Trust Co.*, 475 F. Supp. at 10.

13. See generally *Hearings on Regulation under Federal Banking and Securities Laws of Persons Involved in Corporate Takeovers Before the Senate Comm. on Banking, Housing and Urban Affairs*, 94th Cong., 2d Sess. (1976); *Hearings on Financial Institutions and the Nation's Economy Before the Subcomm. on Financial Institutions Supervision, Regulation and Insurance of the House Comm. on Banking, Currency and Housing*, 94th Cong., 2d Sess. (1976); *Legal Times of Washington*, March 26, 1979, at 1, col. 1.

14. See *Herzel & Rosenberg*, *supra* note 1; *Legal Times of Washington*, *supra* note 13.

15. Potter, *Financing and Other Aspects of Cash Tender Offers—A Panel: The Role of the Commercial Bank*, 32 *BUS. LAW.* 1415 (1977).

16. Letter from G. William Miller to Chairman of the House Comm. on Banking, Finance and Urban Affairs, *quoted in Legal Times of Washington*, *supra* note 13.

17. *Legal Times of Washington*, *supra* note 13; Comment, *Bank Financing of Hostile Takeovers of Borrowers: Washington Steel Corp. v. TW Corp.*, 93 *HARV. L. REV.* 440, 444-45 (1979).

18. *Legal Times of Washington*, *supra* note 13; *Herzel & Rosenberg*, *supra* note 1, at 678.

other hand, are concerned about the unfair competitive advantage that may be gained by an offeror solely through its choice of lending institution.

At its core, the problem is one of balancing a number of considerations: the interest of the target corporation in maintaining the integrity of its proprietary information and business objectives, the goals of the antifraud provisions of the federal securities laws, and the recognized need for readily available bank financing. The purpose of this Note is to set forth an analytical framework of the problem. In order to ascertain the nature of a bank's obligations it will be necessary to examine both the policies that underlie the relationship between a bank and its corporate borrower and the expectations of the parties when they enter a lending agreement.

Working from the model factual setting provided by *Washington Steel* and *American Medicorp*,¹⁹ four general theories of bank liability will be addressed: a per se breach of the relationship between a bank and its corporate borrower,²⁰ a breach of the bank-borrower relationship by appropriation of confidential information,²¹ a breach of the bank-borrower relationship by indirect disclosure of confidential information,²² and liability for selective disclosure of material nonpublic information under the antifraud provisions of the federal securities laws.²³ This fourth issue was not raised in either the *Washington Steel* or the *American Medicorp* case, but is an analogous application of federal securities regulation to the same incidents which give rise to a common law action. Liability of the offeror under these categories will also be examined where appropriate. The Note concludes that while the target of a takeover may seek injunctive relief under either the federal securities laws or the common law, a proper balancing of the rights of the parties to a hostile takeover can be carried out only through special legislation or regulation.

I. CREATION OF A SPECIAL OR FIDUCIARY RELATIONSHIP BETWEEN A BANK AND ITS CORPORATE LOAN CUSTOMER

Historically, the relationship between a bank and its borrower

19. See text accompanying notes 5-7 *supra*.

20. See notes 35-55 *infra* and accompanying text.

21. See notes 56-102 *infra* and accompanying text.

22. See notes 103-20 *infra* and accompanying text.

23. See notes 121-83 *infra* and accompanying text.

has been viewed as a debtor-creditor agreement with few obligations placed upon the bank beyond the express terms of the loan.²⁴ It is now well established, however, that contemporary loan transactions between a lender and its customer may give rise to more extensive duties,²⁵ which are commensurate with the degree of trust and confidence placed in the bank by its client. A customer does not rely on a bank to counsel it on every material fact relating to its business or finances when it is only a depositor.²⁶ Nevertheless, a special or fiduciary relationship may be created when the customer relies on the bank as a financial advisor²⁷ or establishes a course of dealing in which nonpublic information concerning its finances or objectives is transmitted to the bank in confidence.²⁸ The form of this relationship has been variously labeled as fiduciary,²⁹ agency³⁰ or implied contract,³¹ but whatever the label, it is the mutual understanding and reasonable expectations of the parties that define the nature of their dealings and give rise to their obligations.

A corporation and its banker often develop longstanding ties, for a lending arrangement is particularly conducive to substantial interaction. The size and complexity of capital development loans necessitates cooperation between the two entities over an extended period of time. Moreover, major loans to corporations involve a profound analysis of repayment feasibility. Accordingly, banks request or require certain financial data from the corporate customer as a precondition to the loan. In the course of an established relationship, the bank will accumulate a great deal of information about the internal workings, status and objectives of a

24. See generally Hagedorn, *Fiduciary Aspects of the Bank-Customer Relationship*, 54 MO. BANKING J. 406 (1978).

25. See notes 32-33 *infra*.

26. See, e.g., Klein v. First Edina Nat'l Bank, 293 Minn. 418, 196 N.W.2d 619 (1972).

27. See Stewart v. Phoenix Nat'l Bank, 49 Ariz. 34, 64 P.2d 101 (1937); Pigg v. Robertson, 549 S.W.2d 597 (Mo. Ct. App. 1977). Cf. Stenberg v. Northwestern Nat'l Bank of Rochester, 307 Minn. 487, 238 N.W.2d 218 (1976) (indicating that even though the plaintiff had relied on the defendant bank as a financial counselor, the plaintiff's ability as an experienced businessman negated the fiduciary character of the relationship).

28. See Pigg v. Robertson, 549 S.W.2d 597 (Mo. Ct. App. 1977); M.L. Stewart & Co., Inc. v. Marcus, 124 Misc. 86, 207 N.Y.S. 685 (Sup. Ct. 1924).

29. Stenberg v. Northwestern Nat'l Bank of Rochester, 307 Minn. 487, 238 N.W.2d 218 (1976); Pigg v. Robertson, 549 S.W.2d 597 (Mo. App. 1977); M.L. Stewart & Co., Inc. v. Marcus, 124 Misc. 86, 207 N.Y.S. 685 (Sup. Ct. 1924).

30. Spratlin, Harrington & Thomas, Inc. v. Hawn, 116 Ga. App. 175 (1967); Peterson v. Idaho First Nat'l Bank, 83 Idaho 578, 367 P.2d 284 (1961).

31. Peterson v. Idaho First Nat'l Bank, 83 Idaho 578, 367 P.2d 284 (1961); Milohnich v. First Nat'l Bank of Miami Springs, 224 So.2d 759 (Fla. Dist. Ct. App. 1969).

corporation, much of which is confidential or nonpublic.³² Because of the sensitive nature of these materials and the mutual recognition of their confidentiality, it is understood that the information will not be disseminated to persons outside the relationship for purposes other than a valid business interest of the corporation.³³ In this manner, a special relationship of confidence is created with regard to the information transmitted.

Yet, the bank's fiduciary duties may go beyond this minimal construction: the obligations are established by the express or implied agreement between the bank and its customer. The courts that have considered this relationship in the context of financing a hostile takeover have recognized the existence of some special relationship between a bank and its corporate borrower, but have differed on the degree and nature of the bank's obligations.³⁴

32. However, one court has drawn attention to the question of whether the materials that are transmitted to a bank by a prospective borrower are truly "confidential." The issue is one of incremental disclosure. As confidential information is transmitted to other entities such as accountants for tax purposes, attorneys for legal counseling, financial consultants, and to some extent material suppliers for credit evaluation, the dissemination lessens the nonpublic nature of the information. *American Medicorp, Inc. v. Continental Ill. Nat'l Bank & Trust Co.*, 475 F. Supp. 5, 8 (N.D. Ill. 1977). The relevance of this dissemination to a potential breach of a confidential relationship by the bank is questionable. It is the understanding of the parties to the relationship and not the nature of the material which ultimately determines the violation. See text accompanying notes 61-67 *infra*; Note, *Bank Financing of Involuntary Takeovers of Corporate Customers: A Breach of a Fiduciary Duty?*, 53 NOTRE DAME LAW. 827, 836 (1978).

The issue of the "qualifiedly confidential" nature of the materials may be a more significant question in determining materiality under federal securities law. See the discussion of materiality in text accompanying notes 121-23 *infra*. See also Herzel & Rosenberg, *supra* note 1, at 678 for a discussion of a bank's ability to show nonmateriality in litigation.

33. See Hagedorn, *supra* note 24, at 410-11. Information contained in depositor accounts is subject to the same nondisclosure protection. See *Milohnich v. First Nat'l Bank of Miami Springs*, 224 So.2d 759 (Fla. Dist. Ct. App. 1969); *Peterson v. Idaho First Nat'l Bank*, 83 Idaho 578, 367 P.2d 284 (1961). For a discussion of this point in connection with federal securities law, see SEC Exchange Act Release No. 11374, [1974-1975 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 80,167 (Commission's view that projections on future corporate earnings, transmitted in the context of a confidential relationship for a valid business purpose of the issuer, should not be selectively disclosed).

34. The district court opinion in *Washington Steel* found an agency relationship existed. 465 F. Supp. at 1103. The appellate court's position on the issue of the existence of a special relationship is less clear, but its denunciation of the district court's interpretation of the duty owed by the bank as too sweeping implicitly recognizes the existence of a narrower duty. 602 F.2d at 599. The court in *American Medicorp* implied that a bank's reliance on the confidential information of one borrower in connection with a loan to a second borrower would breach the special relationship. 475 F. Supp. at 8. In a case arising from the same set of facts, Judge Lasker cited Judge McMillen's *American Medicorp* opinion as expressly recognizing a fiduciary relationship and agreed with that conclusion:

[W]e share the view of Judge McMillen, expressed in the transcript of the Medicorp-Continental case before him on December 5, 1977, that a special rela-

A. *Scope of Duties: Per Se Breach of Fiduciary Obligations of a Bank to its Corporate Borrower by Financing a Hostile Takeover*

In both the *Washington Steel* and *American Medicorp* controversies, the target company contended that a bank breached a fiduciary duty to its corporate borrower by the act of financing the hostile acquisition of that borrower:³⁵ participation in the takeover of a customer allegedly placed the lender in a position of conflict between the protection it owed the interests of the target and its own pecuniary interest in the earnings which would be received from the loan to the offeror. Of course, this argument is premised on the notion that when a bank and a corporate borrower establish a lending arrangement, a fiduciary relationship is created whereby the bank impliedly agrees to further the best interests of the corporation.³⁶ Hence, participation in a hostile takeover is a per se breach of this agreement.³⁷ A second, related charge is that in establishing a similar relationship with the offeror corporation—which has interests directly adverse to the first borrower—an inevitable conflict arises. The basis for this argument is the general agency theory that a person cannot simultaneously represent two opposing parties without failing to pursue the best interests of one of them.³⁸ Therefore, a subsequent loan arrangement constitutes a breach of the former arrangement.³⁹

tionship which may be designated fiduciary or confidential, does exist between a prospective borrower and its bank which should preclude the bank from disseminating or using the information for improper purposes.

Humana, Inc. v. American Medicorp, Inc., [1977-1978 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,286 at 92,829 (S.D.N.Y. 1978).

35. For a general discussion of bank fiduciary duties, see Hagedorn, *supra* note 24.

36. Brief of Appellee at 29, *Washington Steel Corp. v. TW Corp.*, 602 F.2d 594 (3d Cir. 1979).

37. Brief of Appellee at 14, *Washington Steel Corp. v. TW Corp.*, 602 F.2d 594 (3d Cir. 1979). For quintessential statements on the notion of general fiduciary duties, see *Meinhard v. Salmon*, 249 N.Y. 458, 164 N.E. 545 (1928), and *SEC v. Chenery Corp.*, 318 U.S. 80 (1943).

38. RESTATEMENT (SECOND) OF AGENCY § 390 (1958).

39. Judge Simmons, in *Washington Steel Corp. v. TW Corp.*, 465 F. Supp. 1100 (W.D. Pa. 1979), found a breach of the relationship between the bank and its target borrower from the bank's failure to notify the target of the existence of a dual agency relationship. Such a disclosure conceivably could cure the breach of a duty to disclose material information to the target. Yet, the disclosure would nevertheless breach a duty owing to the offeror; the offeror would reasonably expect the bank to refrain from such disclosure because the information supplied to the bank by the offeror in the course of its loan relationship with the bank is also transmitted with the expectation that *this* information will remain confidential. Additionally, the disclosure of an intention to make a tender offer may have serious "tipping" consequences under the federal securities laws. *See* note 121

The application of a per se breach of fiduciary duty necessarily implies a broad conception of the scope of a banker-borrower relationship. Such a conception, however, is not a necessary incident of the relationship. In general, unless constrained by statute, the nature and extent of a fiduciary relationship are determined by the parties.⁴⁰ However, absent an express provision in a loan arrangement which prohibits the bank from dealing with other clients who may have interests hostile to the borrower, such an understanding can only be inferred from the circumstances surrounding the agreement.⁴¹ If a corporation enters into the loan arrangement with the presumed understanding that a bank has existing or potential relationships with many organizations, some of which will certainly have interests in competition with or adverse to those of the borrowing corporation, its expectations must be appropriately tailored to the commercial context. A broad prohibition of all action adverse to the interests of the borrower must, therefore, be based upon some additional circumstances accompanying the loan arrangement.

The scope of a bank's duties to its borrower is defined by the particular transactions which the relationship encompasses.⁴² Those courts which have imposed broad duties on a bank have focused on the special degree of trust or confidence which the customer in that particular relationship placed in the lender.⁴³ Un-

infra; SEC Exchange Act Release No. 16385, [1979-1980 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 82,374, 18 SEC DOCKET 1092 (Nov. 29, 1979).

40. RESTATEMENT (SECOND) OF AGENCY § 376 (1958).

41. See *Lutcher S.A. Celulose e Papel v. Inter-American Dev. Bank*, 382 F.2d 454, 460 (D.C. Cir. 1967) (noting that no duty exists independent of contract which limits a bank's ability to lend to competing businesses).

42. The plaintiff, Washington Steel Corp., focused on this point in attempting to argue that the capital development program that was being financed by the loan from Chemical Bank would be curtailed if the takeover was completed. Brief of Appellee at 28-29, *Washington Steel Corp. v. TW Corp.*, 602 F.2d 594 (3d Cir. 1979). See note 44 *infra*.

43. The Minnesota Supreme Court stated its opinion on the point in *Klein v. First Edina Nat'l Bank*, 293 Minn. 418, 196 N.W.2d 619 (1972):

We believe the correct rule to be that when a bank transacts business with a depositor or other customer, it has no special duty to counsel the customer and inform him of every material fact relating to the transaction . . . unless special circumstances exist, such as where the bank knows or has reason to know that the customer is placing his trust and confidence in the bank and is relying on the bank so to counsel and inform him.

Id. at 422, 196 N.W.2d at 623. See also *Stewart v. Phoenix Nat'l Bank*, 49 Ariz. 34, 64 P.2d 101 (1937) (special duty of bank when serving as financial counselor); *Richfield Bank & Trust Co. v. Sjogren*, 309 Minn. 362, 244 N.W.2d 648 (1976) (duty to disclose insolvency of one customer to another client when bank has knowledge of possible fraud and special relationship exists); *Pigg v. Robertson*, 549 S.W.2d 597 (Mo. Ct. App. 1977) (possible duty of bank personnel to disclose personal interest in subject matter of loan).

less the degree of trust placed in a bank by the borrower is enough to make the reasonable expectations of the borrower greater than those which would normally be understood in this commercial setting, a bank is free to pursue any relations with parties whose interests are adverse to the first borrower, so long as the purpose of the existing loan relationship is not endangered.⁴⁴ Thus, to contend that a bank's relationship with its borrower implied a general duty not to act adversely to the borrower's interest is to assume too much. Accordingly, a bank's participation in a hostile takeover is not, without more, a per se breach of fiduciary duty.

Moreover, a cash tender offer may not be detrimental to a target corporation.⁴⁵ A corporation is essentially an aggregation of the interests of its shareholders,⁴⁶ and, when an offer is made, a shareholder is given an opportunity to obtain a premium for his or her interest which could not normally be secured in the marketplace. More likely, then, it is the interest of the present target management which is threatened by a takeover and which provides the incentive for combat. Using this analysis, if a tender offer is not adverse to the interests of the shareholders, it may be argued that no breach of even the purportedly broad fiduciary duty of a bank occurs by its financing a hostile takeover.

In denouncing the applicability of an absolute prohibition on banks financing the hostile takeover of a corporate borrower, both the appellate decision in *Washington Steel* and the *American Medicorp* opinion focused on the practical consequences of recognizing this concept. The paramount consideration of both courts was that such a ban would "tend to burden the free flow of bank financing and the ability which a bank now has to deal with cus-

44. When the purpose of the loan is the financing of a corporate program such as capital development, the bank's obligations would seem to extend to not taking any action which would proximately injure that program. In *Washington Steel* it was not shown that TW Corp. intended the destruction of the target's program as was contended. If such a curtailment was intended it may have been the acts of new management and not the takeover which would have resulted in injury to the development program. See Comment, *supra* note 17, at 446.

Even if a broad agency relationship is deemed to exist between a bank and its borrower, an agent is permitted to have more than one principal so long as one relationship does not compete with or injure another. The comment to § 391 of the *Restatement (Second) of Agency* notes that an agent may deal with competing parties "if such dealing is not inconsistent with his duties to the principal."

45. This issue was not addressed by any of the courts in *Washington Steel* or *American Medicorp* but was raised by Chemical Bank in its brief to the appellate court. Brief of Appellant at 35-36, *Washington Steel Corp. v. TW Corp.*, 602 F.2d 594 (3d Cir. 1979).

46. *Id.*

tomers who may have adverse interests to other customers."⁴⁷ From the standpoint of legal precedent, if the per se theory were recognized, it would be difficult to ascertain circumstances in which a bank could have *any* relations with two parties who might have potentially competing objectives.

The most compelling basis for the per se theory is an application of traditional agency concepts as evidenced by the district court decision in *Washington Steel*.⁴⁸ Presumably, a bank would not be restricted from having *depositors* who were in competition with one another,⁴⁹ for this would fall within the recognized exception to the dual agency prohibition that an agent may serve two competing principals if its responsibilities involve only ministerial tasks.⁵⁰ However, the discretionary character of a *lending* relationship goes beyond ministerial tasks.⁵¹ A bank raises suspicions of breached duty when it finances a project for one borrower and thereby directly contravenes a business objective of the previously established relationship. It is in just such a situation that bankers would be reluctant to enter a lending arrangement, and the flow of bank financing would be restricted. Rather than risk potential liability for a breach of duty, and more importantly the legal battle initiated by a disgruntled borrower, a prudent banker will refrain from lending. This uncertainty would lead to overly conservative lending decisions.

A second concern stemming from the recognition of an absolute prohibition is the creation of a common law anti-takeover defense.⁵² By arranging for a series of loans from those major banks which participate in tender offer financing, a company could effectively make itself "takeover-proof": no potential offeror would be able to obtain the necessary financing.⁵³ Indeed, a similar series of lending relationships might partially shield a company from ordinary competition and enable it to establish a dominant market

47. *Washington Steel Corp. v. TW Corp.*, 602 F.2d at 601 (citing and agreeing with Judge McMillen's conclusion in *American Medicorp, Inc. v. Continental Ill. Nat'l Bank & Trust Co.*, 475 F. Supp. at 10).

48. 465 F. Supp. at 1103-05.

49. Banks do, however, have a duty to maintain the confidentiality of a depositor's account. See note 33 *supra*.

50. RESTATEMENT (SECOND) OF AGENCY § 394 (1958).

51. Judge Simmons' opinion failed to clarify precisely what it is about a lending arrangement that gives rise to broad agency duties.

52. *Washington Steel Corp. v. TW Corp.*, 602 F.2d at 601.

53. Because of the size of a tender offer loan, only a limited number of banks are potential sources of financing. Thus, it would not be too difficult for a potential target company to protect itself in this manner. See Comment, *supra* note 17, at 444.

position. The introduction of a new product line or manufacturing concept could be financed through such a network of loans, thereby restricting potential competitors from securing start-up capital from the same lending institutions.⁵⁴ Banks would be reluctant to finance a company engaging in an enterprise which has a purpose potentially adverse to that of an existing borrower.

Considering the substantial revision of current banking practices which would ensue from the recognition of a *per se* breach, the courts are prudently hesitant to make a sweeping statement on the fiduciary duties attendant to a lending relationship. Also, since common law developments require extensive case by case refinement, banks would have little guidance in determining which loans might subject them to liability. Judge Gibbons was correct when he stated that "establishing a *per se* common law fiduciary duty of banks to their borrowers seems archetypically within the domain of legislative judgement."⁵⁵

B. *The Bank's Appropriation of a Target's Confidential Information in Evaluating the Loan to the Offeror*

A second, more perplexing question is presented when a bank appropriates and uses the nonpublic information that it has received from an established corporate customer in evaluating a subsequent loan to another corporate borrower. This problem is compounded when the second borrower intends to use the proceeds of the loan for the acquisition of the first. Assuming that there is no *direct* transmission of the nonpublic information to the subsequent borrower, the issue is whether such appropriation and use of proprietary information by the bank constitutes a breach of its relationship with the target borrower.

The issue was addressed in dicta in both *American Medicorp* and *Washington Steel*.⁵⁶ Judge Gibbons, in the *Washington Steel* appellate opinion, reasoned that, as a matter of policy, internal use of nonpublic information should be permitted:

To prohibit a bank from considering all available information in making its own loan decisions might engender one or both of two undesirable outcomes. First, it might force banks to go blindly into loan transactions, arguably violating its [*sic*] duties to its [*sic*] own depositors. Alternatively, such a rule might dis-

54. This point was raised by Judge Gibbons in *Washington Steel Corp. v. TW Corp.*, 602 F.2d at 601.

55. *Id.*

56. Neither court found actual use of the confidential information.

courage banks from lending money to any company which expresses an interest in purchasing shares of stock of another of the bank's customers. The adverse implications of this result for the free flow of funds is precisely the reason why we rejected the *per se* rule urged by Washington.⁵⁷

The two district courts which examined the *American Medicorp* tender offer both concluded that a bank may not rely on the target's confidential information when making the tender offer loan evaluation, but neither decision gave an explanation of this view.⁵⁸

A fundamental problem impedes the use of all available information in loan evaluations. Any information that a borrower gives to a bank during the tentative stages of a lending relationship serves to establish not only the feasibility of the loan, but also the mutual expectations of the parties. Indeed, the quality and quantity of this information limits the extent to which special or fiduciary relations control the behavior of the parties⁵⁹ and is consequently an important element of their lending relationship.

An analogy can be drawn to the situation in which a prospective seller of a product approaches a prospective buyer and in the process of negotiations discloses information about the manufacturing process. As applied in the context of this Note, a borrower corporation is selling its ability to repay a loan to a prospective lender, and nonpublic proprietary information provides the incentive for the deal. Such a buyer-seller situation was addressed in *Heyman v. A.R. Winarick, Inc.*,⁶⁰ where the plaintiff desired to sell the defendant a business that produced a nonpatented liquid fingernail hardener. The plaintiff contended that in the ultimately unsuccessful negotiating process certain trade secrets were disclosed to the prospective buyer. Five months after discussions terminated, the defendant began marketing its own liquid hardener. In examining the nature of the relationship between the parties pertaining to the use of information that was disclosed during negotiations, the court held the circumstances and understandings of the parties to be controlling:

57. 602 F.2d at 603.

58. *American Medicorp, Inc. v. Continental Ill. Nat'l Bank & Trust Co.*, 475 F. Supp. at 8; *Humana, Inc. v. American Medicorp, Inc.* [1977-1978 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,286, at 92,829 (S.D.N.Y. 1978). The issue of internal misuse of confidential information was not addressed by the *Washington Steel* district court opinion. 465 F. Supp. 1100 (W.D. Pa. 1979).

59. See notes 40-45 *supra* and accompanying text.

60. 325 F.2d 584 (2d Cir. 1963).

While there is no indication that plaintiff extracted from defendants a promise of trust with respect to information disclosed during negotiations, an express agreement is not a prerequisite to the establishment of a confidential relationship. . . . A relationship of trust and confidence may naturally result from the circumstances surrounding the dealings between the parties. . . . Where, as here, the parties are a seller and a prospective purchaser, certain disclosures will usually be made about the thing which is for sale so that the purchaser may rationally assess the merits of concluding the bargain *As the prospective seller is given the information for the limited purpose of aiding him in deciding whether to buy, he is bound to receive the information for use within the ambit of this limitation.*⁶¹

Thus, the understandings of the parties as to the basis on which information is transmitted establishes the confidential nature of that information for purposes of the particular relationship.⁶² If the recipient of information knows that the issuer intends the contents to be confidential and accepts them as such, then the understanding is binding regardless of whether the recipient could have gained the knowledge from another source.⁶³ Even if the information given to the bank by a prospective borrower—specifically, projections on future earnings and intended capital development plans⁶⁴—could be compiled from another source, the manner in which they were received would preclude the use of those particular materials outside the loan transactions

61. *Id.* at 587 (emphasis added). This case was ultimately dismissed because no use of the confidential information was found at the trial level. The appellate court held that this finding was not clearly erroneous. *Id.* at 590.

62. For a discussion of "qualifiedly confidential" information, see note 32 *supra*.

63. *Heyman v. A.R. Winarick, Inc.*, 325 F.2d 584, 590-91 (2d Cir. 1963).

64. In *Washington Steel* the court noted the nature of the materials transmitted: Chemical received certain information, some of which was non-public in nature. This information included a May, 1973 Study produced by Washington, providing cash flow and earnings projections for Washington through 182. In addition, Washington supplied Chemical with quarterly statements of its financial affairs as well as a year-end statement dated December 28, 1978, for the fiscal year ending September 30, 1978.

602 F.2d at 596.

The *American Medicorp* case involved similar information, which, as noted by Judge McMillen, is probably representative of the types of information present in most long-term lending arrangements:

Such information includes many types of financial reports, including a five-year projection, all of which were obtained by the defendant in order to evaluate making a loan to plaintiff and entering into another banking relationship with it. They are, we believe, the customary package of documents presented by a prospective borrower to a financier, and we assume they were presented with the understanding that they would be retained in a confidential posture within the bank, and also not disclosed to outsiders.

475 F. Supp. at 8 (emphasis added).

for which they were transmitted.⁶⁵

Bank cases support the argument that a lender may not appropriate for its own use information confidentially supplied by a prospective borrower. In *Pigg v. Robertson*⁶⁶ the plaintiff approached the defendant, whom he believed to be an officer of the bank, and disclosed his desire to obtain a loan for the purchase of a farm.⁶⁷ The defendant told the plaintiff that he could not make the loan with the type of collateral offered.⁶⁸ Subsequently, the defendant entered a contract to purchase the farm that plaintiff had intended to buy.⁶⁹ The court held that a jury would have been entitled to find that the plaintiff's disclosures were subject to the obligations of a confidential relationship,⁷⁰ and that the defendant's actions constituted a breach of those obligations.

Similarly, in *M.L. Stewart & Co. v. Marcus*⁷¹ the court examined the duties of a recipient of confidential information obtained in the course of lending negotiations.⁷² The plaintiff contended that it had approached the defendant bank officer for a future loan and in the ensuing conversation disclosed information concerning an impending purchase of property, thereby creating a fiduciary relationship.⁷³ The defendant allegedly breached a duty to the plaintiff by acting as an agent for another party in the purchase of the same property.

This case is significant for its treatment of the relationship be-

65. In *Brophy v. Cities Service Co.*, 31 Del. Ch. 241 (1949), the court noted the general duty of nonappropriation which arises when an employee learns of confidential business information: "[I]f an employee in the course of his employment acquires secret information relating to his employer's business, he occupies a position of trust and confidence toward it analogous in most respects to that of a fiduciary. . . ." *Id.* at 244. The fiduciary duties of a recipient of confidential information stem from an appreciation of the import of the information received and not necessarily the position of the individual receiving the information. See note 67 *infra*.

66. 549 S.W.2d 597 (Mo. Ct. App. 1977).

67. The defendant in this case was not an officer of the bank but an outside auditor who had been using the bank president's office. He had answered questions for bank customers when they were directed to him by bank employees. The court found that a jury could, therefore, find that a bank customer approaching the defendant on the direction of a bank employee would expect his confidences to be respected. It was noted that a jury could find that the defendant "could reasonably be expected to know that such reliance was being placed in him." *Id.* at 601.

68. *Id.* at 599.

69. *Id.*

70. *Id.* at 602.

71. 124 Misc. 86, 207 N.Y.S. 685 (Sup. Ct. 1924).

72. The court ultimately found that no confidential information had been transmitted, and that which was conveyed was inaccurate. *Id.* at 94, 207 N.Y.S. at 693.

73. *Id.* at 88, 207 N.Y.S. at 687-88.

tween bank and borrower when nonpublic information has been transmitted during their dealings.⁷⁴ In reasoning that "not the nominal, but the actual, relation of the parties must be examined in order to determine whether there has been a breach of trust,"⁷⁵ the court noted that "a trust or fiduciary relation in its strict sense . . . is created only by mutual consent, express or implied."⁷⁶ The court, however, then noted that a bank encourages the submission of information in a confidential posture:

Of course, no man can obtrude either his trust or his secrets upon another, to the extent of imposing upon that other any obligation in regard thereto, any more than he can render another his bailee invitum. In that respect banks present a constant invitation to intending borrowers, and thus subject themselves to whatever implication or obligation is to be drawn from that fact. . . .

Moreover, I assume that if a person applies for a loan, and in connection with that application discloses his purpose to avail of a bargain which he had not as yet closed by contract, and of which the lender had not previously heard, the courts, whether of law or equity, would afford some form of adequate relief in case the applicant was forestalled in his project by the lender.⁷⁷

This line of reasoning is clearly applicable to a bank's appropriation of the confidential information supplied by one borrower in connection with a loan to another borrower. In establishing its lending relationship with the first borrower, the bank invites, indeed requires, the submission of proprietary information from that borrower. Certainly, the use of that information outside of that relationship is not an element of the parties' mutual consent. Accordingly, use of that information for one party's institutional benefit constitutes a breach of the resultant confidential relationship.⁷⁸

74. In light of the court's holding, its statements on this point, though significant, are dicta. See note 72 *supra*.

75. 124 Misc. at 90, 207 N.Y.S. at 690.

76. *Id.* at 89, 207 N.Y.S. at 689.

77. *Id.* at 92-93, 207 N.Y.S. at 692.

78. In the recent case of *Walton v. Morgan Stanley Co., Inc.*, 623 F.2d 796 (2d Cir. 1980), the Court of Appeals for the Second Circuit examined the duties of an investment banker regarding confidential information received from a target company in the context of tender offer negotiations.

In *Walton*, Morgan Stanley solicited and received favorable confidential internal earnings projections from Olincraft, Inc. for use in connection with a prospective bid for Olincraft by Kennecott Copper Corp. Olincraft supplied this information with the instruction that it was to be used solely for the Kennecott bid and was to be returned if the bid did not go through. *Id.* at 797. Kennecott did not bid, but after another company, Texas Eastern

An action brought by a target corporation which is based on the appropriation of its proprietary information would raise the issue of whether damage to the target is a necessary element of the claim. The issue has already been raised in defending a shareholder's derivative action against a corporate officer or director who traded in the securities of his or her company. In *Diamond v. Oreamuno*⁷⁹ the New York Court of Appeals determined that under the common law of that state, damage to the corporation is not a necessary element of a cause of action founded on a breach of fiduciary duty.⁸⁰ Under this rule, damage computation will be

Corp., announced its intention to acquire Olincraft, Morgan Stanley purchased 149,200 shares of Olincraft for its own account. *Id.* at 797. After this purchase, Morgan Stanley disclosed the confidential Olincraft information to Johns-Manville in an effort to induce a higher bid from Johns-Manville. *Id.* Johns-Manville ultimately outbid Texas Eastern, and a merger of Johns-Manville and Olincraft was arranged. Subsequently, a suit was filed by former Olincraft shareholders, seeking an accounting of the profits received by Morgan Stanley in its purchase and sale of Olincraft stock.

Judge Morris Lasker of the District Court for the Southern District of New York dismissed the complaint on the ground that plaintiffs lacked standing because of their failure to allege that injury to Olincraft resulted from Morgan Stanley's actions. *Id.* at 798. On appeal, the Court of Appeals for the Second Circuit affirmed the dismissal on a new ground: Morgan Stanley had dealt with Olincraft on an arm's length basis and owed no fiduciary duty to Olincraft which would prevent its disclosing the Olincraft information to Johns-Manville. Therefore, the plaintiff had failed to state a claim. Essentially, the court held that mere receipt of confidential information, without a further fiduciary relationship, does not support a duty to preserve the confidentiality of that information.

While the majority opinion found no duty to preserve the confidentiality of Olincraft's information absent a more compelling fiduciary duty, *Id.* at 798-99, Judge Oakes' dissent offered a position similar to that advocated in this Note. He found that although Morgan Stanley was not an agent of Olincraft and, as it was hired by the prospective bidder Kenne-cott, had no pre-existing duty to that company, a duty did exist to preserve the Olincraft information.

[A]fter Olincraft began to cooperate in the deal by turning over the "Confidential Inside Information" as to favorable earnings prospects, I think the acceptance of such information by Morgan Stanley, on the confidential terms, along with its understood role as an intermediary in a cooperative takeover, imposed a duty on the investment banker under well-established common law principles not to use that information for its own profit.

Id. at 801. Where the majority would require evidence of some extraordinary agreement in order to sustain the plaintiff's case, Judge Oakes would infer such an agreement from acceptance of the information, along with knowledge of the terms of transmittal. *Id.* at 801 n.3.

Both investment bankers, as corporate marriage-brokers, and commercial banks, as financiers of tender offers, are repositories of confidential information. Information which is transmitted and received specifically within the confines of a particular transaction—here, the Kenne-cott bid—is intrinsically an element of that transaction. Hence, the disclosure or use of that information by either an investment bank or a commercial bank for its own benefit is a violation of the duty to preserve that information.

79. 24 N.Y.2d 494 (1969).

80. *Id.* at 498. See also *Higgins v. Shenango Pottery Co.*, 256 F.2d 504, 508 (3d Cir. 1958) (the test of liability is unjust enrichment, not damage to the corporation, when a

based solely upon the unjust enrichment of the party appropriating confidential information.

Other jurisdictions follow an opposing view and require that injury to the corporation be shown in order to maintain a derivative action for damages. In *Schein v. Chasen*⁸¹ the Florida Supreme Court expressly rejected both the *Diamond* rule and a proposed extension of that rule which would have embraced a recipient of confidential information who was not party to a fiduciary relationship with the corporation.⁸² Similarly, in *Freeman v. Decio*⁸³ the Court of Appeals for the Seventh Circuit determined that Indiana law would follow the Florida approach, and it required proof of injury to a corporation whose information had been utilized by a director for his own personal benefit.⁸⁴

The two positions may be distinguished on the basis of the characterization given to the appropriated corporate information. The *Diamond* approach views nonpublic proprietary information as an asset of the corporation to which corporate fiduciaries owe a duty of loyalty.⁸⁵ The alternate approach implies only a duty of care, not a duty of loyalty, and therefore requires injury to the corporation before a remedy is available.⁸⁶

If the *Diamond* rule is followed, the use of confidential materials by a fiduciary for its own benefit, without authorization by the issuer of the information, gives rise to a cause of action, with a remedy of the profits obtained.⁸⁷ When a bank appropriates information supplied by a borrower for use in determining the de-

director utilizes the assets or business opportunities of the corporation for personal benefit); *Brophy v. Cities Service Co.*, 31 Del. Ch. 241, 246 (1949) (public policy will not permit an employee occupying a position of trust and confidence to benefit from that position regardless of whether loss to the corporation is found).

81. 313 So.2d 739 (Fla. 1975).

82. *Id.* at 746.

83. 584 F.2d 186 (7th Cir. 1978).

84. *Id.* at 196. The court of appeals chose not to employ the Indiana certified question statute, thereby declining to put the issue to the Indiana Supreme Court, because it found that there was no basis for the claim that the corporation's stock was sold on the basis of inside information. *Id.* at 189 n.8.

85. The court in *Freeman v. Decio* analyzed the *Diamond* rule in such terms but held that it might be better to determine whether loss to the corporation is present before determining whether there has been a breach of the duty of loyalty. The *Freeman* court's position was likened to that of the corporate opportunity doctrine, which inquires whether loss is present before deciding that an opportunity is present. 584 F.2d 186, 193 (7th Cir. 1978).

86. *Freeman v. Decio*, 584 F.2d 186, 193-94 (7th Cir. 1978); *Schein v. Chasen*, 313 So. 2d 739, 746 (Fla. 1975).

87. *Diamond v. Oreamuno*, 24 N.Y.2d 494, 498 (1969). The *Diamond* court relied heavily on the opinion in *Brophy v. Cities Service Co.*, 31 Del. Ch. 241 (1949). See note 80 *supra*.

sirability of making a loan to another client, its initial "profits" take the form of a competitive advantage over other banks from which the offeror could seek financing. Since the first borrower corporation treats its proprietary information as confidential, this knowledge will not be publicly available. If this nonpublic information is relevant and material to the second borrower's ability to repay the loan under consideration, the bank will have a more accurate picture of the second borrower's financial condition and will therefore be able to make a more informed decision.⁸⁸ Accordingly, a bank which has special, nonpublic knowledge of this variety may be willing to make a loan which another lending institution would regard as unjustifiably risky.⁸⁹ The bank would thus reduce the risk of its loan decision and thereby gain pecuniary benefit.

The foregoing analysis presents a problem in determining what relief the injured party may receive: the actual advantage to the bank is difficult to quantify in monetary terms. It may also be difficult, if not impossible, to ascertain what percentage of the bank's return on the loan is attributable to the use of nonpublic information. Of course, if it can be shown that, without the knowledge appropriated from its other customer, the bank would not have made the loan, then all of the profit received by the lender would be traced to the appropriation. If, on the other hand, by virtue of the nonpublic information and the favorable picture it paints regarding the second borrower's credit risk, the bank is simply willing to lend money at a lower rate than it would have had not the confidential information been employed, it would seem that none of the profit would result from the appropriation.⁹⁰ Furthermore, due to the discretionary character of lending, it may be very difficult for the injured borrower to prove that the bank did not rely solely on the information supplied by the second borrower. Thus, the party who has suffered the breach may have a right without a remedy.

88. For a discussion of the circumstances in which information of the target-borrower is particularly relevant to a second borrower's repayment ability in the context of a hostile takeover, see notes 108-10 *infra* and accompanying text.

89. Of course, this would not be so if the target corporation had similar lending arrangements with other major banks and these banks also chose to use information in a similar manner. If the offeror-corporation sought financing from such a lending institution, the same result would occur.

90. However, this analysis ignores the risk factor involved in tender offer loans. Benefit to the bank in the form of reduced risk in deciding to lend on information not available to other lenders would still be present.

In the context of a hostile takeover in which the second borrower intends to use the proceeds of the loan for the acquisition of the first, the target corporation is not concerned primarily with recovering the bank's profits; it is more interested in preventing the bank from participating in its acquisition. It would seek to enjoin the bank from lending to the offeror and thereby gain time in which to develop a more complete anti-takeover strategy or seek a more favorable offer.⁹¹ Moreover, considering that it is a breach of a fiduciary relationship which has occurred, along with the difficulty in quantifying both the amount of benefit received by the breaching party and the damage to the target, an injunction may be the most appropriate relief.⁹²

If the rationale of *Schein* and *Freeman* is the theoretical basis on which a target corporation must structure its action for injunctive relief, a different problem is encountered: it would have to be shown that irreparable harm will result to the target if the loan is permitted to proceed and the tender offer to continue.⁹³

If the target's confidential information paints an unfavorable financial picture and indicates that the acquisition of the target will not significantly contribute to the offeror's total earnings, the bank may establish a lower per share limit to which it will lend the offeror. The shareholders of the target might then receive less money per share than they would have had the bank not used the confidential information in assessing the loan to the offeror-borrower. Alternatively, if the target's nonpublic information reveals a more favorable financial position than can be ascertained by publicly available data, the bank may be willing to lend more to the offeror. With a higher per share loan commitment, the offeror may be willing to bid a higher price for the shares held by the target's stockholders. In this scenario, the target company would benefit from the bank's appropriation of the target's information rather than suffer a loss.

It will, however, be difficult for a target corporation to show the price differential which results from the bank's use of its infor-

91. See generally Steinbrink, *supra* note 1.

92. This was the remedy sought in both *American Medicorp* and *Washington Steel*. Injunctive relief is also the means of preventing future harm arising from a continuing scheme whereby the bank retains the benefit of its appropriation until the purchase has been consummated and the loan repaid. See also RESTATEMENT OF RESTITUTION § 166 (1937).

93. The failure of *American Medicorp, Inc.* to show irreparable harm was one of the factors on which the District Court for the Northern District of Illinois denied the company's action for a preliminary injunction. 475 F. Supp. at 10.

mation. Because of the discretionary nature of lending, no single piece of information controls the amount to which an offeror will be able to borrow. Therefore, in attempting to establish irreparable injury from internal use of its information, a target corporation may be required to identify some other element of loss.

A more subtle, though significant, injury to the target shareholders occurs in the form of diminished bargaining capacity. In the situation where, because of the bank's use of confidential information in setting a per share loan figure, the offeror has the same information which is available to the target, an artificial ceiling is placed on the negotiable offering price.⁹⁴ The result may be a lower price offered to the shareholders. Of course, the shareholder has the option of rejecting the offer and retaining his or her holdings. Nevertheless, if the top price that the offeror is willing to bid has been set by the bank's maximum per share figure and is lower than the offeror's originally calculated maximum price, the median negotiable price has been lowered by the bank and the target shareholder has less leverage.

As a practical matter, a target corporation which suspects that its lending bank has misused proprietary information faces a difficult burden of proof.⁹⁵ Furthermore, once a cause of action is made out, injunctive relief preventing the bank from further participation in the financing of the tender offer may be the only appropriate remedy. Nevertheless, under certain circumstances the incentive for use of the information may be substantial,⁹⁶ and

94. Ordinarily the shareholders of a corporation, through their management, have a better estimation of the true worth of their company than any outside source. A corporation wishing to acquire the target will evaluate both its own financial condition and that of the target from all available information and fix a break-even price at which it believes the investment equals the price offered. The target company makes a similar evaluation of its own worth, but because of superior information may set its figure higher or lower than that of the offeror. In the bargaining process each party seeks to maximize its gain. The offeror will bid a price which it believes to be lower than the true value of the target, yet attractive enough to cause the target's shareholders to sell. The target shareholders will respond by accepting the offer if they perceive this to be the best price they can obtain. If not, the offer will be rejected and the offeror-corporation will respond with a second bid, higher than the first but still less than the figure it has fixed as a break-even point. The negotiations will continue in this manner until a price is reached at which each party believes it has achieved the maximum gain possible.

95. This is particularly true when confidential information does not actually pass hands between loan officers, but rather remains with the same personnel who have worked on prior loans to the target and have had access to the confidential information in connection with those previous transactions, but who are also involved with the loan to the offeror.

96. See notes 108-10 *infra* and accompanying text.

when this motive is coupled with a proof burden which may be virtually impossible to sustain, an absolute prohibition on banks entering into such tender offer financing may be the only feasible way to regulate potential abuse.⁹⁷

The ramifications of such a conclusion parallel those of an absolute prohibition based on the duty not to act adversely to a borrower's interests: a new defense strategy for potential targets will be created.⁹⁸ A more innovative and less commercially burdensome approach would place a rebuttable presumption of misuse on a bank which chooses to participate in financing the takeover of its corporate borrower.⁹⁹ Of course, "it seems highly desirable that the potential for conflict should be avoided by the voluntary behavior of the bank itself"¹⁰⁰—that is, by not participating in the financing.

From the foregoing analysis it is apparent that a target corporation may have a sound argument on which to establish a claim for injunctive relief and thereby prevent a bank which has used the target's nonpublic information from participating in the target's acquisition. As previously noted, the court in *American Medicorp* agreed with this reasoning, but the *Washington Steel* appellate decision took the opposite position.¹⁰¹ The policy considerations on which the *Washington Steel* court grounded its beliefs—that banks will be forced to proceed blindly, without the use of all available information, and that the free flow of bank financing will be restricted by excessive caution on the part of lenders to corporations¹⁰²—ignore the fact that information supplied to the bank in a confidential lending relationship is an element of that relationship. Consequently, its use is restricted by the parameters of the expectations of the parties.

C. *Indirect Disclosure to the Offeror of Confidential Information Received from the Target*

A second breach of fiduciary duty may contemporaneously oc-

97. See generally Mendez-Penate, *The Bank "Chinese Wall": Resolving and Contending with Conflicts of Duties*, 93 BANKING L.J. 674, 687-88 (1976) (noting that all lending department activities of a bank may be tainted with the knowledge of confidential information).

98. See text accompanying notes 24-31 *supra*.

99. See notes 185-91 *infra* and accompanying text.

100. *Humana, Inc. v. American Medicorp, Inc.* [1977-1978 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,286 at 92,829 (S.D.N.Y. 1978).

101. See text accompanying notes 56-58 *supra*.

102. 602 F.2d at 603.

cur with the internal use of confidential information supplied by one client in connection with a loan to a second borrower—a breach which takes the form of an indirect or disguised disclosure of that information. As previously noted, there is a general duty not to disclose information which has been transmitted and received in a confidential posture,¹⁰³ an aura of trust and confidence encompasses the issuer and recipient of nonpublic materials. A bank is not at liberty to disclose the details of a depositor's account,¹⁰⁴ nor may it directly disclose information which has been transmitted to the bank by a customer in connection with a lending transaction. In short, courts will find that "a special relationship which may be designated fiduciary or confidential does exist between a prospective borrower and its bank which should preclude the bank from disseminating or using the information for improper purposes."¹⁰⁵ As noted above, the understanding of the parties regarding the confidential nature of the materials governs how they are to be maintained.¹⁰⁶

In a proposed hostile takeover, if the offeror knows of the bank's internal use of the target's confidential proprietary information in assessing the loan to the offeror, a disguised revelation of the information results. There is a statement on the desirability of the acquisition implicit in the granting of the loan.¹⁰⁷ Conversely, a denial of the loan may carry an implicit negative statement. A more significant revelation—and a more explicit violation of a confidential relationship—occurs when the bank grants a loan to an offeror-borrower expressly for use in making a cash tender offer for the shares of the target-customer, but conditions the loan upon a particular per share offering price, or range of prices. If the bank agrees to extend the loan, but sets a maxi-

103. See text accompanying notes 32–33 *supra*.

104. See, e.g., *Stewart v. Phoenix Nat'l Bank*, 49 Ariz. 34, 36, 64 P.2d 101, 106 (1937); *Milohnich v. First Nat'l Bank of Miami Springs*, 224 So.2d 759, 762 (Fla. 1969).

105. *Humana, Inc. v. American Medicorp, Inc.* [1977–1978 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,286 at 92,829 (S.D.N.Y. 1978).

106. See text accompanying notes 62–65 *supra*.

107. This argument was raised and rejected in *American Medicorp*. See Note, *supra* note 32, at 836. See also Letter from SEC Chairman Harold M. Williams to Senator William Proxmire and accompanying Exhibits (Feb. 15, 1980), reprinted in [Current] SEC. REG. & L. REP. (BNA) Special Supplement No. 542 at 9 [hereinafter Williams Letter], noting that when a bidder learns of a bank's possession of material nonpublic information concerning the target company, it may draw an inference regarding either the nature of the information possessed or the desirability of the target as an acquisition. For reference to indirect disclosure in connection with possible Rule 10b–5 implications, see Comment, *supra* note 17, at 448.

imum per share price limit, it participates in the decisionmaking of the offeror's management.

A variation on this form of indirect transfer takes place when the offeror approaches the bank for tender offer financing and informs the bank of the range of possible bid prices it intends to use. In using its confidential knowledge of the target to decide that it will grant a loan sufficient to cover this range, the bank impliedly states to the offeror that the acquisition would be a sound transaction within the range of prices set forth. In this sense, the bank provides an independent confirmation of the accuracy of the offeror's analysis. The superior information possessed by the bank supplements management's information and assures that the offeror has selected a sound range of bid prices. The stronger the inference of the desirability of the acquisition for the offeror, the more valuable the disguised information is to the offeror, and the more significant or direct the disclosure.

Two important reservations must be attached to this notion of an indirect disclosure. First, the information on the target's financial condition must be of substantial importance to the bank. Although knowledge of the target's ability, once acquired, to contribute to the offeror's total earnings is always of some value to the bank, a bank will not ordinarily base its loan decision exclusively on the target's financial health; there are too many contingencies involved in a hostile takeover.¹⁰⁸ For example, in the loan to Humana by Continental Illinois National Bank and Trust Company, a "worst case analysis" approach was used in determining whether the bank would finance Humana's intended takeover of American Medicorp.¹⁰⁹ By this method, an analysis was made of the offeror's ability to repay the proposed loan in the event that it was unable either to gain total control of the target or to divest its partial holdings. The financial condition of the target was of relatively minor importance. In such a situation, authorization of the loan may convey little information by inference to the offeror. It is important to note, however, that the greater the size of the target in proportion to that of the offeror, the greater the target's ability to enhance the offeror's ability to repay the loan after the acquisi-

108. Judge McMillen noted in *American Medicorp* that because of the peculiar context of a hostile takeover, a lender would not be wise to make a loan on "the assumption that the assets of the company to be acquired were required to repay the loan." *American Medicorp, Inc. v. Continental Nat'l Bank & Trust Co. of Chicago*, 475 F. Supp. at 9.

109. *Humana, Inc. v. American Medicorp, Inc.*, [1977-1978 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,286 at 92,829 (S.D.N.Y. 1978).

tion. This is particularly true when the offeror is highly leveraged and will rely heavily on the target's cash flow for repayment.¹¹⁰ In such circumstances the bank would put greater weight on a target's financial position in evaluating the offeror's total cash flow following the acquisition.

The second qualification on an assertion of indirect disclosure concerns the offeror's awareness of the lender's possession of the target's confidential proprietary information. If the offeror does not know that the bank possesses confidential information about the target's financial condition, it can infer only that the bank views the offeror's repayment ability favorably. It would reasonably assume that the bank based its decision on the offeror's present assets, projected future earnings—both with and without the addition of the target—and whatever publicly available information exists about the target. If, however, the borrower knows of the bank's possession and use of nonpublic information concerning the target's finances, or can reasonably assume that the bank has used such information because of the size and cash flow problems addressed above, it may regard the loan as an endorsement of the propitiousness of the takeover.¹¹¹

The only case to address the concept of indirect disclosure, *American Medicorp*, reflected strong reservations on the content of the implied statement.

[I]t does not tell outsiders anything which they did not already know or should be able to infer. They knew or could easily have discovered that plaintiff [target] was a customer of the defendant [bank] and had a substantial business banking relationship with it, from which it would follow that [defendant bank] had obtained considerable favorable information from the plaintiff.¹¹²

Thus, *American Medicorp* would imply that if a statement on

110. This point was noted by counsel for Washington Steel. Brief for Appellee at 38, *Washington Steel Corp. v. TW Corp.*, 602 F.2d 594 (3d Cir. 1979).

111. An established, notorious policy of nonuse or the presence of an information transfer barrier between loan accounts would negate the reasonableness of the assumption. See text accompanying notes 185-91 *infra*. If no such policy exists, and the offeror is aware of sizable lending agreements between the bank and the target, the offeror could reasonably assume that the target supplied the bank with the same types of information that it was required to supply in connection with its tender offer loan negotiations. Therefore, the offeror would have a good idea of the type of information about the target that was possessed by the bank.

112. 475 F. Supp. at 9. This comment is essentially dicta. Judge McMillen disregarded evidence that although Continental had informed Humana and other participating banks that it possessed confidential information about American Medicorp, it would not pass on such information. *Id.*

the condition of the target is implicit in granting the loan to the offeror, that statement embodies only publicly available information and therefore is not an improper disclosure.

This line of reasoning, however, is subject to two criticisms. First, the existence of an established lending relationship does not by itself support an inference that the target is in sound financial condition. Second, restrictions on the purchase price imposed by the lending bank generate a more pointed inference as to the value of the target than would an unconditional approval of the loan. When the offeror is aware that the lender has analyzed the financial condition of the target, any price limitation imposed by the lender operates as the guidance of an independent analyst.¹¹³ The result is that the offeror has acquired the benefit of an informed second opinion.

Because of the possibility of indirect information transfer, an offeror may derive a substantial competitive advantage over other offerors through the choice of its lender. The target's bank, aware of detailed proprietary information, may be willing to make the loan to the offeror, while a bank without such information might not. In addition, if the bank limits the per share price to be paid, the offeror may develop a clearer analysis of the target's true value. Benefit to the offeror may have adverse consequences for the shareholders of the target, for indirect disclosure to the offeror may reduce the bargaining leverage of the target's shareholders.¹¹⁴ For example, if the lender imposes a low per share price ceiling, the acquisition may be carried out at a price lower than that which may have been obtainable without the direct or indirect conveyance of proprietary data to the offeror.

The bank also derives benefit from its use of the confidential information and indirect transfer to the offeror.¹¹⁵ If, because of its special knowledge of the target's condition, the bank is willing to finance the tender offer where another institution would not, or if it is willing to lend to a higher per share amount than it would have had not the confidential information been employed, then all or a substantial increment of return on the loan is attributable to the use of the information.

In seeking a remedy for the breach of a fiduciary relationship

113. For a discussion of the types of information on which the offeror could assume the bank had based its decision, see note 101 *supra*.

114. See text accompanying notes 94-95 *supra*.

115. This benefit is similar to that derived from appropriation. See text accompanying notes 85-89 *supra*.

based on an indirect disclosure of confidential information, the target will encounter the same difficulties inherent in a breach by misuse: damage to the shareholders in the form of a lower price per share offer will be very difficult to show and benefit to the bank virtually impossible to ascertain.¹¹⁶ Because of these difficulties in determining a monetary remedy, injunctive relief would again seem the most appropriate course to pursue, particularly because the target's goal is to prevent the transaction before a public bid is offered. The model presented in this Note contemplates the target's discovery or suspicion of the use of its information before any actual sale of stock has occurred. At that point in the sequence of events, the bank has received no measurable benefit from including its knowledge of the target's financial conditions in its loan decision. The offeror, however, has received the information through the implied disclosure. Injunctive relief would prevent the bank from receiving the fruits of its transgression and would limit the additional harm to the target which would flow from culmination of the tender offer.

An action against the offeror presents a different problem. It is the act of disclosure which constitutes the breach, not receipt of the information. The recipient who has done nothing to encourage or assist in the breach is, in a sense, a bystander. Also, like the benefits received by the bank and the damage to the target, any advantage gained by an offeror through this form of disguised disclosure is difficult to quantify. Yet, as a practical matter, an injunction which prevents the bank from continued participation in the tender offer also operates against the offeror. An injunction will give the target the benefit of delay and force the offeror to seek other financing.

More importantly, an injunction prohibiting the offeror from making a public bid for the shares of the target is the only method of preventing a second disclosure and denying the offeror the benefits of the bank's wrong. This is so because, as the offeror appreciates the nonpublic nature of the information it receives, it becomes a holder of that confidential information; an unintentional confidential relationship between the target and the offeror is created and the offeror should be bound by an obligation of nondisclosure.¹¹⁷ Yet, the public bid for the shares of the target

116. See text accompanying notes 89-95 *supra*.

117. In *Schein v. Chasen*, 313 So.2d 739, 743-46 (Fla. 1975), the Florida Supreme Court expressly rejected the theory that a confidential or fiduciary relationship is created between a corporation and a party who receives confidential information through an inter-

may result in a second indirect disclosure because it may change the perceptions of the target's value held by the target's creditors and other potential offerors. By making the same reasonable assumptions that the offeror makes about the bank's incentive for using nonpublic material, these other parties may know or have reason to know of the bank's possession and use of the target's information in making the loan to the offeror. The price which is bid for the shares may then be perceived by these outside parties as reflecting a more accurate analysis of the value of the target than the present market price reflects, thereby altering the public perception of the target, and resulting in a second breach by inferential disclosure.

Notwithstanding the many opportunities for indirect disclosure of confidential information, a target corporation bears a heavy burden of proof. Not only must internal misuse be demonstrated, but the knowledge of such by the recipient and the relevance of the target's information to the offeror's financing must be proven as well. Because the bank has the same incentive for use in this context as in appropriation without disclosure, an equal or stronger argument can be made for the absolute prohibition of such behavior as the only feasible means of preventing potential abuse.¹¹⁸

With the exception of the cursory treatment given by Judge McMillen in *American Medicorp*,¹¹⁹ the issue of indirect disclosure has not been considered by the courts. In part, this may be due to the limited circumstances in which a bank would use information regarding one client in connection with a loan to another. Nevertheless, in the situation where a bank has sufficient incentive for such use, and the second client knows of both the bank's posses-

mediary, and it adopted the position of the dissenting opinion from the federal appellate decision on that case. 478 F.2d 817 (2d Cir. 1973) (Kaufman, J., dissenting), *vacated and remanded sub nom. Lehman Bros. v. Schein*, 416 U.S. 386 (1974), *remanded and certified to the Florida Supreme Court*, 313 So.2d 739 (Fla. 1975).

The reasoning of the Florida court would also seem to be the logical progression of the Second Circuit's analysis in *Walton v. Morgan Stanley Co., Inc.*, 623 F.2d 796 (2d Cir. 1980), discussed at note 78 *supra*. In that case the court held that the direct recipient of information from a subject company owes no duty to that company and may both disclose the information and use it for profit as long as there is no special relationship of trust and confidence between the parties. It would follow that an individual who received confidential information of the subject company *indirectly* through a financial intermediary and who had no pre-existing relationship with the subject company would have no duty to refrain from using the information for its own benefit.

118. See note 117 *supra*.

119. See text accompanying notes 111-13 *supra*.

sion of confidential information and the probability that it will be incorporated as a primary element of the lending decision, an argument for a breach of fiduciary duty by disclosure of confidential information is compelling.¹²⁰

II. VIOLATION OF RULE 10b-5

The same set of facts which may give rise to a breach of a fiduciary obligation by indirect disclosure of confidential information may also provide the basis for a private cause of action for "tipping" under section 10(b),¹²¹ the general antifraud provision of the Securities Exchange Act of 1934, and the Securities and Exchange Commission's Rule 10b-5.¹²² These provisions are directed at both "the existence of a relationship giving access, directly or indirectly, to information intended to be available only for a corporate purpose"¹²³ and the unfairness which results when a party uses such nonpublic information for its own benefit in dealing with those who do not have such information.¹²⁴

The possibility of applying these antifraud provisions to the factual setting presented in this Note has not been addressed by any court. It is clear, however, that acceptance of this theory would turn on the recognition that some form of information transfer has occurred between a bank and an offeror when the bank grants a tender offer loan based on an analysis which includes nonpublic information about the target. The applicability of Rule 10b-5 to such a scenario will depend upon the characterization of the information transfer as selective disclosure or tipping. In general, persons whose special relationship to a publicly traded corporation gives them access to material nonpublic information are not permitted either to disclose or trade selectively upon that information, or to recommend that others do so, unless the nonpublic information is disclosed to the general investing

120. The validity of this argument would be diminished by the presence of some form of internal mechanism at the bank which prevents information transfer between loan accounts. See text accompanying notes 185-91 *infra*.

121. 15 U.S.C. § 78j(b) (1976). "Tipping" is the act of giving inside information to outsiders in a breach of trust. *Ross v. Licht*, 263 F. Supp. 395, 410 (S.D.N.Y. 1967).

122. 17 C.F.R. § 240.10b-5 (1980). A private cause of action under these provisions is a judicial creation. See *J.I. Case Co. v. Borak*, 377 U.S. 426 (1964). Judge Gibbons noted in *Washington Steel* that a violation of the antifraud provisions could have resulted from a direct disclosure of information from the bank to the offeror. 602 F.2d at 604.

123. *Cady, Roberts & Co.*, 40 SEC 907, 912 (1961).

124. *Id.* See also *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833 (2d Cir. 1968); *Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, [1967-1969 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 77,629 (1968).

community.¹²⁵ The selective disclosure or deceptive device which constitutes a violation is not limited to a single form. "These anti-fraud provisions are not intended as a specification of particular acts or practices which constitute fraud, but rather are designed to encompass the infinite variety of devices by which undue advantage may be taken of investors and others."¹²⁶

Three transgressions of the antifraud provisions may arise from an indirect disclosure of nonpublic information regarding a target firm. First, if a statement on the desirability of the acquisition is implicit in granting a loan to the offeror-borrower, a recommendation to purchase the shares of a corporation may be made on the basis of nonpublic information. Second, if setting a per share amount which it will lend the offeror-borrower constitutes assistance in the offeror's determination that the value at which the price it pays equals the worth of the investment, the bank may have indirectly disclosed the information on which it has based its computation. Third, if the offeror-borrower reasonably perceives the loan as a recommendation to buy or the per share lending limitation as a statement of the value of the target, while knowing the types of nonpublic information used in the bank's decision, subsequent purchase of the stock may constitute trading on non-public information.¹²⁷

125. See, e.g., *Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 495 F.2d 228, 236 (2d Cir. 1974); *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 848 (2d Cir. 1968); *SEC v. Lum's Inc.*, 368 F. Supp. 1046, 1057 (S.D.N.Y. 1973). "Nonpublic information" under federal securities law differs from the concept under common law principles, where fiduciary obligations pertaining to the information arise from the understandings and expectations of the parties. The concept of material inside information under Rule 10b-5 is "based in policy on the justifiable expectation of the securities market place that all investors trading on impersonal exchanges have relatively equal access to material information. . . ." *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 848 (2d Cir. 1968).

Information is material, in this application, where there is a "substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available." *TSC Indus., Inc. v. Northway, Inc.*, 426 U.S. 438, 449 (1975). Although the Court in *TSC* was addressing the concept of materiality in the context of a violation of Rule 14a-9, this definition has been applied to violations of Rule 10b-5 by the courts. See, e.g., *SEC v. Bausch & Lomb, Inc.*, 565 F.2d 8, 15 (2d Cir. 1977).

An agreement between the bank and the borrower on the confidentiality of the materials can be waived or altered, but the obligations arising under the antifraud provisions cannot be modified by the parties. *Herzel & Rosenberg, supra* note 1, at 676-77 n.1.

126. *Cady, Roberts & Co.*, 40 SEC 907, 911 (1961).

127. Generally, a person who purchases stock on the basis of material inside information without disclosing that information does not engage in a fraud within the meaning of § 10(b) and Rule 10b-5 unless there is a duty to disclose the information. Such a duty does not arise from the mere possession of nonpublic market information. In the recent case of *Chiarella v. U.S.*, 445 U.S. 222 (1980), the Supreme Court affirmed this principle and held

An initial consideration in determining whether a tip has occurred through the tender offer financing described in this Note is the materiality¹²⁸ of the information which has been disclosed, or upon which a recommendation is based. The nonpublic information in this instance involves primarily projections of future sales and earnings of the target corporation,¹²⁹ and it is clear that this type of information is the most material knowledge a prospective trader can obtain.¹³⁰ Earnings projections play a crucial part in computing the present value of a corporation and thus would be considered significant by a reasonable investor. Therefore, the *direct* revelation of this information would certainly meet the test of materiality. However, because of the indirect, inferential manner of transmittal involved in granting the tender offer loan, a more thorough analysis is required.

Few tender offer acquisitions of any consequence can be carried out without a financing loan. The material information on which the bank bases its loan determination is embodied in the analysis transmitted to the offeror, and it serves as a positive statement of the desirability of the acquisition. Similarly, when used to compute a per share limit on bank financing, the material information contributes to a more specific determination on what will be the highest bid offered for a share of the target's stock. As previously noted, the decision of the bank consequently assists the offeror's management in its decision regarding the value of the investment and the calculation of the range of the price to be bid.¹³¹ Thus, the fact that the confidential information was used by the bank in calculating a bid price is evidence of the information's materiality. Given the inherent materiality of earnings pro-

that liability under these antifraud provisions "is premised upon a duty to disclose arising from a relationship of trust and confidence between parties to a transaction." *Id.* at 230. However,

"Tippees" of corporate insiders have been held liable under § 10(b) because they have a duty not to profit from the use of inside information that they know is confidential and know or should know came from a corporate insider, *Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 495 F.2d 228, 237-38 (CA 2 1974). The tippee's obligation has been viewed as arising from his role as a participant after the fact in the insider's breach of a fiduciary duty.

Id. at 230 n.12.

128. See note 125 *supra*. See also Comment, *supra* note 17 (questioning the materiality of information conveyed in this manner).

129. For a discussion of the types of materials involved in *American Medicorp* and *Washington Steel*, see note 64 *supra*.

130. *SEC v. Bausch & Lomb, Inc.*, 420 F. Supp. 1126, 1238 (S.D.N.Y. 1976), *aff'd* 565 F.2d 8 (2d Cir. 1977); *SEC v. Lum's Inc.*, 365 F. Supp. 1046, 1057 (S.D.N.Y. 1973).

131. See notes 107-08 *supra* and accompanying text.

jections, it follows that the disclosure of the information, a recommendation to buy within the established price range, and evidence of its materiality in the offeror's decision are all established simultaneously.

In the prototypical case of a Rule 10b-5 violation by selective disclosure, the materiality of the disclosed information is an element separate and distinct from the use of the information by the tippee in its decision to buy or sell securities.¹³² Although in all cases there must be some relation between the disclosure of the information and market activity,¹³³ in limited circumstances the two concepts will be so intertwined that they may function as one. The implied disclosure and recommendation contained in the grant of a tender offer loan, under the circumstances assumed by this Note, presents a particularly cogent example of this interconnection.

*S.E.C. v. Lum's, Inc.*¹³⁴ involved such a disguised recommendation to trade securities. In that case, the court addressed a situation in which an institutional salesman for Lehman Brothers received confidential information from a corporation which indicated an unexpected, undisclosed downturn in earnings. The information was transmitted in confidence through a special relationship established between the corporation and that particular salesman.¹³⁵ The salesman had subsequent conversations with an institutional dealer during which he implied that the corporation would experience an unexpected drop in earnings.¹³⁶ In determining whether the disclosure was "in connection with the purchase or sale" by the institutional dealer, the court noted the

132. *SEC v. Lum's Inc.*, 365 F. Supp. 1046, 1059 (S.D.N.Y. 1973). As stated by a different court,

[I]t seems clear from the legislative purpose Congress expressed in the Act, and the legislative history of Section 10(b) that Congress when it used the phrase "in connection with the purchase or sale of any security" intended only that the device employed, whatever it might be, be of a sort that would cause reasonable investors to rely thereon, and, in connection therewith, so relying, cause them to purchase or sell a corporation's securities.

SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 860 (2d Cir. 1968).

133. *See SEC v. Lum's Inc.*, 365 F. Supp. 1046, 1059 (S.D.N.Y. 1973).

134. 365 F. Supp. 1046 (S.D.N.Y. 1973).

135. *Id.* at 1052-54.

136. As the opinion reported:

Jundt [agent for institutional dealer] testified that he remarked to Simon [salesman] that something must be wrong at Caesar's Palace [subsidiary of Lum's, Inc.], and that the latter responded, "I have a gut feeling you're right". Sit [agent for institutional dealer] recalled that Simon "did not quarrel" with their decision to sell.

Id. at 1059.

link with materiality under these circumstances: "Although the 'in connection with' and 'materiality of the information' requirements are generally treated as separate elements of liability in a 10b-5 action, . . . the two would seem to come together when a discreet bit of inside information is conveyed and allegedly triggers a discreet sale of a security."¹³⁷ The existence of a unique relationship between the salesman and the corporation was cited as supporting the notion that in special circumstances inference alone may constitute a material disclosure:

More significantly, Sit [an agent of the institutional dealer] . . . reported that Simon [salesman] had ventured as a personal conclusion that [the corporation] would have higher expenses and lower earnings. This evidence alone might be dispositive, given Simon's unique relationship to Lum's and his prior recommendation to [the dealer] to buy Lum's stock. In *Texas Gulf* all that defendant Darke had apparently said to one of his alleged tippees was that the company "was a good buy." And it should be remembered that the prohibitions of Rule 10b-5 extend to "recommending" the stock affected while in receipt of any material inside information.¹³⁸

The relationships outlined in *Lum's* are analogous to those present in a takeover loan decision. The offeror's knowledge of both the bank's special relationship with the target and the bank's use of confidential information in the loan determination strengthens the statement implied by the granting of the loan.¹³⁹ As in *Lum's*, the materiality of the information on which the inference is based is contained in the implied statement.¹⁴⁰ This implied statement is both a recommendation and a disclosure. Because the information transfer from the bank to the offeror is inferential, it may be easier to demonstrate a recommendation to an offeror who knows of the bank's use of material information

137. *Id.*

138. *Id.*

139. In his response to an inquiry by U.S. Senators William Proxmire, Paul S. Sarbanes, and Harrison A. Williams, Jr., concerning the applicability of the federal securities laws to tender offer financing, Harold M. Williams, Chairman of the Securities and Exchange Commission, noted that a bank's effective disclosure of material, nonpublic information regarding the target to an offeror may result in the bank's liability as a tipper. However, Chairman Williams expressed the view that if the bank does not *directly* disclose the information, but merely uses it in making its loan determination, the "in connection with" requirement of a 10b-5 action may be lacking. Williams Letter, *supra* note 107. It would seem, however, that the implied statement and inferential disclosure envisioned by *Lum's* would supply this missing element and complete the cause of action.

140. Circumstantial evidence may be used to prove that a recipient gave greater weight to a statement than its intrinsic materiality would justify. *See, e.g., SEC v. Geon Indus., Inc.*, 531 F.2d 39, 46 (2d Cir. 1976).

than to specify precisely what information has been passed. Under the peculiar circumstances of a tender offer loan arrangement, a recommendation to purchase the shares of the target at an agreed upon price range is also a form of disclosure.

Courts are not ordinarily confronted with assertions of "tipping" arising from tender offer financing. Consequently, derivation of an appropriate remedy is also a rare occurrence. In the case of an indirect transfer of information, the standard method of correcting a selective disclosure before trading is a dissemination of the information to the general investing public.¹⁴¹ However, because of the inferential manner in which the offeror has received the information, it may be difficult to release publicly that which has been obtained. A disclosure of the fact that a loan has been secured from a bank, or even the fact that a loan has been obtained for an offer to be made at a particular price range, may not reveal to the public what it reveals to that particular offeror.

This is so because the range of bid price established by the concerted actions of the bank and the offeror is made on an evaluation of the worth of the target to that particular offeror, and includes information about the offeror's finances as well as information about the target. Thus, the amount which the offeror is willing to pay, and commensurately the amount which the bank is willing to lend, will be unique to that offeror. Accordingly, unless the bank is willing to disclose publicly the information on which it based its calculations, the material nonpublic information which is contained in the range of price that can be bid will remain undisclosed. Yet, since such a disclosure of the target's proprietary information would subject the bank to liability under common law fiduciary principles,¹⁴² it will be hesitant to take such action and, in fact, might be enjoined from doing so. Thus, since neither the offeror nor the bank can adequately disclose the confidential information at issue, the only effective remedy to prevent trading on that information is to enjoin the offeror from bidding for the target.

Such an injunction must necessarily be permanent, for once the offeror has received the confidential information through its loan negotiations with the bank, it cannot give up that knowledge.

141. See generally *Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 495 F.2d 228, 235-38 (2d Cir. 1974) (the duty to "abstain or disclose" is imposed on both the tippee and the nontrading tipper); *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 848 (2d Cir. 1968).

142. See note 28 *supra*.

Unless some future event destroys the relevance of the confidential information,¹⁴³ any future attempt by the offeror to acquire the target will be based in part on the information. In other words, the manipulative scheme whereby the offeror has gained superior nonpublic knowledge continues so long as the knowledge is material. Of course, the same reasoning should prevent the bank from participating in any subsequent acquisition attempts involving the same parties.¹⁴⁴ Additionally, the bank should be enjoined from any future use of the confidential information of the target corporation; there is a reasonable probability that similar indirect disclosures would result from such transactions.¹⁴⁵

A private damage action under Rule 10b-5 will be difficult to sustain on the theory that the target's shareholders have suffered a loss. As noted above,¹⁴⁶ the loss of bargaining advantage is difficult to quantify. Also, the actual pecuniary loss—based on the difference between what was actually offered for the stock and what would have been offered had not the confidential information been selectively disclosed—will also be difficult to calculate. Moreover, neither of these claims could be asserted until a purchase had actually been made.¹⁴⁷ Finally, the claims present an evidentiary as well as a computational problem; it may be impossible to show that the bid price would have been different without indirect access to the target's confidential information.¹⁴⁸

Permanent injunctive relief is also the most appropriate remedy for a claim brought on the theory that disclosure has occurred through an implied recommendation to acquire the target. An implied recommendation arises from precisely the same actions as the indirect disclosure and results in the offeror possessing precisely the same knowledge—the range of price to be offered which will constitute a wise investment for the offeror. Likewise, the bank will not want to disclose the information on which it based

143. For example, if the nonpublic information were a ten-year projection, the expiration of the relevant period would negate the materiality of the information.

144. Liability under § 10(b) and Rule 10b-5 extends to nontrading tippees as well as trading tippees. *E.g.*, *Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 495 F.2d 228, 237-38 (2d Cir. 1974).

145. This appears to be one of the purposes of an SEC enforcement action. *See, e.g.*, *SEC v. Geon Indus., Inc.*, 531 F.2d 39 (2d Cir. 1976); *SEC v. Bausch & Lomb*, 42 F. Supp. 1226 (S.D.N.Y. 1976); *SEC v. Lum's, Inc.*, 365 F. Supp. 1046 (S.D.N.Y. 1973).

146. *See* note 94 *supra* and accompanying text.

147. For a discussion of the purchaser-seller requirement in private damage actions, see text accompanying notes 163-68 *infra*.

148. For a discussion of showing benefit to a bank from the use of nonpublic information, see text accompanying notes 87-89 *supra*.

its recommendation.¹⁴⁹ The scheme will continue unless a suit enjoins the disclosure of the target's proprietary information, arrests the wrong, and furthers the objective of preventing injury to the shareholders.¹⁵⁰

As under a selective disclosure theory, the effect of the recommendation to purchase the shares of the target at the specified price range remains with the offeror; the knowledge that the acquisition is a sound transaction for the offeror cannot be relinquished. Unless the bank discloses the information on which it based its recommendation, or the target itself releases the same materials to the general public, a permanent injunction is the only way in which the recommendation would not be unfairly utilized by the offeror in a future bid for that target.

A claim for injunctive relief, brought under either a theory of disclosure of material inside information, or of recommendation to deal in securities based on such information, addresses the unfairness which results when one party to a transaction has access to information which is unavailable to the other.¹⁵¹ It must be noted that a violation of Rule 10b-5 is not limited to actual trading on confidential information; the antecedent tip has also been held to violate the antifraud provisions.¹⁵² Under this theory, the act of tipping itself is the wrong which is being redressed.¹⁵³ In the tender offer situation, the interaction of the bank and offeror in setting the price which will be bid constitutes the tip and, consequently, the wrong. The act of making this price public then causes harm to the shareholders, not because they deal with a party who has access to superior information, but because they lose bargaining capacity by virtue of the confidential information incorporated into the bid.¹⁵⁴

Under this notion of violation, disclosure of the information to the general investing public could compound the injury to the target shareholders by diminishing their bargaining capacity in deal-

149. See notes 142-44 *supra* and accompanying text.

150. See *Kahan v. Rosenstiel*, 424 F.2d 161, 173 (3d Cir. 1970) (it is not necessary to establish all the elements of a suit for monetary damages in a claim for equitable relief; the absence of a purchase or sale of securities is not fatal in an action which seeks to enjoin deceptive practices which if continued would lead to completed purchases or sales giving rise to a 10b-5 action).

151. *Cady, Roberts & Co.*, 40 SEC 907, 912 (1961).

152. See, e.g., *Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 495 F.2d 228, 237 (2d Cir. 1974).

153. *Id.*

154. See text accompanying notes 93-94 *supra*.

ing with potential purchasers other than the original offeror. Since the bid incorporates the content of the information transferred through the interaction of the bank and the offeror, when the bid is publicly offered, the target shareholders lose the bargaining advantage which they hold by virtue of the target management's superior knowledge of the value of their company.¹⁵⁵ If the general investing public suspects that the bid price reflects a more accurate valuation of the target's shares because of the offeror's access to the nonpublic information, other potential offerors may alter their estimates accordingly, and thereby reduce the potential leverage that the target shareholders have in the general marketplace.¹⁵⁶ If the confidential information used to compute

155. In the recent case of *Chiarella v. U.S.*, 445 U.S. 222 (1980), the dissenting opinions of Chief Justice Burger and Justice Blackmun indicate a willingness to expand the traditional notions of fraud under § 10(b). Chief Justice Burger argued that the antifraud provisions should be read to include within their reach any person engaged in any fraudulent scheme; they should not be limited only to corporate insiders or deceptive practices related to corporate information, but extended to any scheme whereby an investor is able to exert undue trading advantage. *Id.* at 241 (Burger, C.J., dissenting). As *Chiarella* dealt with an employee of a printer of corporate documents who was able to decode classified information concerning a pending tender offer, and subsequently trade in the securities involved, the Chief Justice concentrated on the deceptive or fraudulent act of misappropriating confidential information. He noted that it was through this fraud that the defendant was able to exert undue trading advantage. *Id.* at 241. In the context of the hostile tender offer discussed in this Note, the offeror obtains nonpublic information about the target through the bank. By virtue of this information the offeror is able to reduce the target shareholders' ability to bargain for the sale of their shares. In other words, because of the fraudulently obtained information, the offeror is able to exert a trading advantage that it would not otherwise have possessed.

Similarly, Justice Blackmun argued for a flexible application of the concept of fraud under the securities laws. In his opinion he contended that even the concept of misappropriation addressed by the Chief Justice should be unnecessary to show a violation of § 10(b).

I would hold that persons having access to confidential material information that is not legally available to others generally are prohibited by Rule 10b-5 from engaging in schemes to exploit their structural informational advantage through trading in affected securities. To hold otherwise, it seems to me, is to tolerate a wide range of manipulative and deceitful behavior.

Id. at 251 (Blackmun, J., dissenting). Even more than the Chief Justice, Justice Blackmun appears to favor a broad reading of § 10(b) and Rule 10b-5, and therefore would apparently sanction an interpretation of these provisions which would include the offeror's exercise of the "structural informational advantage" gained by virtue of its choice of lending institution.

156. To assume that the offer, when made public, constitutes a disclosure of the information selectively received is to assume that the investing public perceives the offer in this manner. If the bid is significantly different from that which any other potential offeror would be willing to make, then the public could draw a reasonable conclusion that either the bidder has access to information which is not generally available, or that the offeror has somehow drastically miscalculated. Since the latter conclusion is unlikely, the former is a more reasonable assumption. Still, unless there is some significant disparity between what

the bid price is unfavorable, the offering price—and the altered estimates of other potential buyers—will be lower than that which would have been offered without the use of the information. Thus, the shareholders will lose an amount equal to the difference between the price offered and the price that would have been bid. Hence, tender of the stock would result in a monetary loss directly traceable to the offeror's receipt of nonpublic information. In this scheme, the bid serves as both a disclosure of the material information selectively received and an injury to the shareholder.

As it is a disclosure of the confidential information—by way of the bid—which results in the harm rather than the nondisclosure of selectively received information, an injunction which prevents the public dissemination of the information is the appropriate remedy. The offeror should be enjoined from making public the bid which incorporates the target's confidential information. Even if the bid would not be perceived by the public as a more accurate valuation of the target company, the offeror should nevertheless be enjoined from bidding for the target and thereby benefiting from the target shareholder's diminished bargaining capacity.

In *Mutual Shares Corp. v. Genesco, Inc.*¹⁵⁷ the Court of Appeals for the Second Circuit grounded injunctive relief in a private action upon justifications similar to those presented above. The case addressed a continuing scheme to manipulate the price of stock in order to acquire the interests of minority shareholders. In endorsing the right of stockholders to enforce a private remedy directed at halting the scheme, the court noted that the antifraud provisions of the securities laws are not limited to legal remedies and should be employed in a broad remedial manner to effectuate their purpose.¹⁵⁸ Such an expansive view was found to be particularly appropriate where unusual burden of proof problems were encountered in a damage action.

Moreover, as already indicated, the claim for damages on this theory [manipulation of market price] founders both on proof of loss and the causal connection with the alleged violation of the Rule; on the other hand, the claim for injunctive relief largely avoids these issues, may cure harm suffered by continuing shareholders, and would afford complete relief against the

is bid by the offeror and what would be bid by any other entity, there may be nothing to trigger suspicion that anyone possesses more information about the target than anyone else. Thus, even though the bid comprises confidential information, if the investing public does not suspect a disclosure, no disclosure is made.

157. 384 F.2d 540 (2d Cir. 1967).

158. *Id.* at 547.

Rule 10b-5 violation for the future. "It is not necessary in a suit for equitable or prophylactic relief to establish all the elements required in a suit for monetary damages."¹⁵⁹

Since injunctive relief is predicated here upon the need to freeze a continuing deceptive scheme before actual monetary damage results to the defrauded party, it would be reasonable to relax traditional rules of standing to allow an injunction to be sought by any party who might be injured by the fraud, and not just a purchaser or a seller of securities. In *Blue Chip Stamps v. Manor Drug Stores*¹⁶⁰ the Supreme Court enunciated the rule that only parties who actually bought or sold securities involving some form of fraudulent dealing had standing to bring a private action for damages under section 10(b) and Rule 10b-5.¹⁶¹ Since the model presented in this Note envisions an action brought before any purchase of the target's stock has been made, a suit for injunctive relief would be the only remedy available for a continuing deceptive scheme.¹⁶²

Courts have acknowledged that a target's ability to assert standing to sue for injunctive relief is necessary for an effective remedy under Rule 10b-5.¹⁶³ It is not surprising, therefore, that cases both before¹⁶⁴ and after¹⁶⁵ *Blue Chip Stamps* have recognized the right of a party who is not a purchaser or a seller to bring such an action. The rationale for these decisions fully comports with the notion of preventing both the offeror, who has received confidential information about a target, and the bank, which disclosed that information, from completing the transaction and thereby profiting from their acts. The Second Circuit's reasoning in *Mutual Shares Corp. v. Genesco, Inc.*¹⁶⁶ is representative:

159. *Id.* (quoting *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 193 (1963)).

160. 421 U.S. 723 (1975).

161. *Id.* at 755.

162. If the fraudulent scheme has terminated, the exception to the purchaser-seller rule may not be available for private injunctive actions. *See, e.g.*, *Heyman v. Heyman*, 356 F. Supp. 958, 964 (S.D.N.Y. 1973).

163. A target corporation was deemed to have standing for a tender offer injunction in *Moore v. Greatamerica Co.*, 274 F. Supp. 490 (N.D. Ohio 1967). This was an analogous situation, where the target sought to prevent the making of misrepresentations to its shareholders.

164. *Landy v. F.D.I.C.*, 486 F.2d 139 (3d Cir. 1973); *Kahan v. Rosensteel*, 424 F.2d 161 (3d Cir. 1970); *Mutual Shares v. Genesco*, 384 F.2d 540 (2d Cir. 1967).

165. *Bertozzi v. King Louie Int., Inc.*, [1976-1977 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 95,840 (R.I. 1976) (equitable relief other than an injunction would be impermissible in view of the purchaser-seller requirement).

166. 384 F.2d 540 (2d Cir. 1967).

[W]e do not regard the fact that plaintiffs have not sold their stock as controlling on the claim for injunctive relief. The complaint alleges a manipulative scheme which is still continuing. While doubtless the Commission could seek to halt such practices, present stockholders are also logical plaintiffs to play "an important role in enforcement" of the Act in this way. . . . Deceitful manipulation of the market price of publicly-owned stock is precisely one of the types of injury to investors that the Act and the Rule were aimed. Since private parties have the right to sue for violation of the Rule, the broad remedial purposes of the Act suggest that the judicial relief available should not be limited to a particular type of remedy.¹⁶⁷

Thus, the courts recognize that an injunctive suit, as contrasted with a damage action, is a prophylactic measure intended to prevent the damage from occurring.¹⁶⁸ Furthermore, it may be the only effective means, other than an SEC enforcement proceeding, of preventing irreparable injury.

One of the most difficult aspects of a target's action for injunctive relief will be the issue of scienter. The Supreme Court in *Ernst & Ernst v. Hochfelder*¹⁶⁹ held that a private action for damages under section 10(b) and Rule 10b-5 requires proof of this element—the intent to deceive, manipulate, or defraud. The hostile takeover model presented by this Note does not constitute a clear case of scienter in the offeror, but merely a discovery or suspicion of the bank's use of the target's confidential information in making the tender offer loan. These circumstances raise the issue of the degree of scienter required to sustain a private injunctive action.

At present, it is unclear precisely what degree of intent is necessary to maintain such an action. The Court in *Hochfelder* specifically declined to consider whether scienter is a necessary element for injunctive relief under section 10(b) and Rule 10b-5.¹⁷⁰ Lower courts focused on what constitutes the appropriate standard for an injunctive action brought by the SEC, rather than the standard of intent required in a private action for injunctive relief.¹⁷¹ The former question was recently resolved by the

167. *Id.* at 546-47. In its proposed Federal Securities Code the American Law Institute recognizes the force of this rationale in commenting: "[N]othing in the Code is inconsistent with the holding in *Mutual Shares Corp.* . . . that the plaintiff need not be a buyer or seller in order to obtain injunctive relief. . . ." ALI FED. SEC. CODE, Comment to § 1603 at (3)(a)(iv) (March 1978 Draft).

168. *See* *Landy v. F.D.I.C.*, 486 F.2d 139, 156 (3d Cir. 1973).

169. 425 U.S. 185 (1976).

170. *Id.* at 194 n.12.

171. *Compare* *SEC v. National Student Marketing*, 457 F. Supp. 682, 710 (1978); *SEC*

Supreme Court in *Aaron v. SEC*,¹⁷² where it was held that scienter is a necessary element in an SEC injunctive action under section 10(b) and Rule 10b-5. Although the Court did not address the issue of scienter in a private suit for injunctive relief, the language of Justice Stewart's majority opinion implies that if the question were presented, the Court would find that scienter is also an element in a private action: "In our view the rationale of *Hochfelder* ineluctably leads to the conclusion that scienter is an element of a violation of § 10(b) and Rule 10b-5, regardless of the identity of the plaintiff or the nature of the relief sought."¹⁷³ Therefore, for purposes of examining the conduct presented by the model under consideration, it will be assumed that the standard of scienter required for an SEC enforcement action is also required for a private injunctive action.

In considering the intent which accompanies the disguised disclosure or recommendation contained in granting a tender offer loan, it is clear that the potential plaintiff will be confronting a difficult burden of proof. Because of the implied or disguised nature of the tip effectuated by the granting of the loan, it may be difficult to show *Hochfelder*-type intent to deceive or defraud. However, courts have mitigated this difficulty by permitting a demonstration of recklessness to satisfy the intent requirement established by *Hochfelder*.¹⁷⁴ The form of reckless behavior accepted by the courts as adequate to maintain a 10b-5 private action is the functional equivalent of intent.¹⁷⁵ In addressing this concept in the context of an actionable omission under Rule

v. Southwest Coal & Energy Co., 439 F. Supp. 820, 825 (W.D. La. 1977); *SEC v. American Realty Trust*, 429 F. Supp. 1148, 1171 (E.D. Va. 1977); and *SEC v. Bausch & Lomb, Inc.*, 420 F. Supp. 1226, 1240-41 (S.D.N.Y. 1976), *aff'd on other grounds*, 565 F.2d 8 (2d Cir. 1977) (requiring scienter in an SEC enforcement proceeding) *with SEC v. World Radio Mission, Inc.*, 544 F.2d 535, 540-41 (1st Cir. 1976) (scienter is not required).

172. 446 U.S. 680 (1980).

173. *Id.* at 691.

174. The Supreme Court indicated the possibility of a recklessness standard in *Hochfelder*, but it did not rule on the issue. 425 U.S. 194 n.12 (1976). For application of the concept of recklessness as sufficient scienter by the lower courts, see *Rolf v. Blyth, Eastman Dillon & Co., Inc.*, 570 F.2d 38 (2d Cir. 1978); *Sundstrand Corp. v. Sun Chemical Corp.*, 553 F.2d 1033, 1045 (7th Cir. 1977); *Baily v. Meister Brau, Inc.*, 535 F.2d 982 (7th Cir. 1976).

175. In *SEC v. Bausch & Lomb, Inc.*, 42 F. Supp. 1226 (S.D.N.Y. 1976), the court reviewed the Second Circuit opinions on this issue. "Their language [Second Circuit opinions], coupled with the Supreme Court's emphasis that scienter means intent to deceive, manipulate or defraud leads to a conclusion that only what Judge Friendly has characterized as the kind of recklessness that is equivalent to fraud will serve as a basis for liability." *Id.* at 1243 n.4 (citing *SEC v. Texas Gulf Sulphur*, 401 F.2d 833, 868 (2d Cir. 1968)). See also *SEC v. National Student Marketing*, 457 F. Supp. 682, 711 (1978).

10b-5, one court noted that by defining recklessness in this manner, it may be said that the reckless person has actually used or employed a deceptive device within the definition of section 10(b):

Under this definition, the danger of misleading buyers must be actually known or so obvious that any reasonable man would legally be bound as knowing, and the omission must derive from something more egregious than even "white heart/empty head" good faith. While this definition might not be the conceptual equivalent of intent as a matter of general philosophy, it does serve as a proper legally functional equivalent for intent, because it measures conduct against an external standard which, under the circumstances of a given case, results in the conclusion that the reckless man should bear the risk of his omission.¹⁷⁶

In applying this concept to the bank's disguised release of confidential information, it must be shown that the bank, as a matter of law, should have understood that the granting of the loan conveyed a substantial amount of material nonpublic information to the offeror. In other words, the implied conveyance of information, or recommendation to trade in securities, must be so clear that any reasonable person could justly be held, as a matter of law, to have knowledge of the information transfer.

A particularly appropriate case for the application of recklessness arose in *Rolf v. Blyth, Eastman Dillon & Co., Inc.*¹⁷⁷ where it was held that a party aiding in the fraud owed a fiduciary duty to the defrauded party. The court examined the liability under Rule 10b-5 of a broker who stood in a fiduciary capacity to a client and had supervisory authority over both the management of that client's discretionary account and the investment advisor who had direct control over the account.¹⁷⁸ Because of this relationship, the court "believe[d] at the very least that fiduciaries have acted with scienter when they have been reckless. . . ."¹⁷⁹ In a like manner, recklessness would seem to be a proper standard by which to examine the conduct of a bank that finances the hostile takeover of a customer.¹⁸⁰

If an offeror-borrower knows that the bank's decision to grant a tender offer loan is based primarily on favorable nonpublic information about the target, and a particular range of bid prices to

176. *Sundstrand Corp. v. Sun Chemical Corp.*, 553 F.2d 1033, 1045 (7th Cir. 1977).

177. 570 F.2d 38 (2d Cir. 1978).

178. *Id.* at 44.

179. *Id.* at 47.

180. For discussion of the special or fiduciary relationship between a bank and its corporate loan customer, see text accompanying notes 24-37 *supra*.

be offered has been set by the bank as a condition of the loan, or if the loan was applied for and granted upon the knowledge that a particular bid price range will be offered, the bank should be aware that it is aiding in a decision of the offeror management. Without doubt, the bank would appreciate the confidentiality of the target's information because of the manner in which it was initially received from the target. Similarly, the materiality of earnings projections is unquestioned and was certainly material to the bank in establishing its loan relationship with the target.

Just as certainly, the offeror would know that the bank will only lend when it believes that the probability of repayment is high. When the offeror is aware that the loan has been preceded by an analysis of whether an acquisition at the specified price range will benefit or detract from the offeror's ability to repay after the acquisition, the offeror may reasonably conclude that the bank's analysis has yielded a favorable judgment. Likewise, when the bank is aware of the offeror's knowledge of the bank's decisionmaking process it must also be aware that its conclusion constitutes a recommendation to proceed with the takeover, if not a transfer of the analysis itself. Thus, the bank's knowledge that the analysis contains material nonpublic information may constitute its requisite scienter. In the same manner, the offeror's knowledge of the interaction establishes its awareness that it now possesses nonpublic information, and its scienter is thereby provided as well.¹⁸¹

The difficulty of showing actual intent to disclose information selectively or to make a recommendation in a situation such as this is precisely the reason for the adoption of recklessness as a standard of scienter.

[A] basis for applying a recklessness standard in certain instances rests perhaps on the practical problem of proof in private enforcement under the securities laws. *Proof of a defendant's knowledge or intent will often be inferential. . . .* To require in all types of 10b-5 cases that a factfinder must find a specific intent to deceive or defraud would for all intents and purposes disembowel the private cause of action under §10(b).¹⁸²

Both the revelation and the intent are inferred in the hostile tender offer loan. Since the antifraud provisions are intended to

181. See note 127 *supra*.

182. *Rolf v. Blyth, Eastman Dillon & Co., Inc.*, 570 F.2d 38, 47 (2d Cir. 1978) (emphasis added).

have flexible application,¹⁸³ the adoption of a recklessness standard promotes the purpose of regulating deceptive practices.

In summary, although no court has addressed the validity of a claim brought under the federal securities law antifraud provisions in the context of a bank financing the hostile takeover of a corporate client, such a claim may be an appropriate basis for injunctive relief. The nonpublic information which is possessed by the bank, through the interaction of the bank and the offeror in setting the range of per share offering prices, may be shown to be both material to the offeror and an element of the offeror's decision to purchase the shares of the target. The knowledge of this interaction by these two parties seems to constitute the requisite scienter for a private action for injunctive relief. Because the target wishes to prevent its takeover from occurring, it will seek to thwart the tender offer before any purchase has been consummated and will, therefore, have standing to sue for injunctive relief in the federal courts under section 10(b) and Rule 10b-5.

III. THE DESIRABILITY OF A "CHINESE WALL"

When considering a loan to be used for the hostile takeover of a corporate borrower, a bank should anticipate the possibility of litigation initiated by the target. The appearance of a conflict of interest will be readily seized upon to bring the matter before the courts and to suspend temporarily the offer. On close scrutiny, the contention that a per se breach occurs upon the establishment of a lending agreement with the offeror lacks legal foundation and is commercially unreasonable.¹⁸⁴ However, the claim that a bank has actually used confidential information supplied by the target in making the tender offer loan evaluation deserves more serious consideration.

Because of the strong case which can be made for bank liability, a wise lender will avoid the use of the target's confidential information. Yet, even a cautious approach may not prevent the filing of a lawsuit. The difficult burden of proof which confronts a target in showing actual use, and the potential for that use when information on the loan accounts of both target and offeror is contained in the same department of the bank, may present a prime case for the imposition of imputed knowledge or use.¹⁸⁵

183. See *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 195 (1963).

184. See note 47 *supra* and accompanying text.

185. This argument was made in *Washington Steel*. Brief of Apellee at 33-48, 602 F.2d

A possible solution to this form of bank vulnerability may be found in erecting a "Chinese Wall" between loan accounts. Although normally offered as a mechanism to prevent the flow of inside information between trust and commercial loan departments of a bank, the characteristics of a "wall" seem applicable to divisions within the loan department as well.¹⁸⁶ The basic elements of a wall would be common in both applications. In general, it is necessary only to establish procedures which are designed to prevent access to confidential materials by anyone other than those bank officers directly concerned with a particular client or transaction, and to publish conspicuously these safeguard procedures.¹⁸⁷

The existence of such safeguard procedures in the loan divisions of a bank could operate as a rebuttable presumption that no disclosure had occurred. If adequate intradepartmental policies existed, a target corporation would have to make a clear showing of the misuse of its confidential information to warrant injunctive relief. This procedural mechanism would alleviate the fear and criticism of a new anti-takeover strategy based upon indirect disclosure of nonpublic information as violations of fiduciary or federal securities law. Alternatively, the absence of such internal safeguards could be deemed to be a presumption of illegal use.

Federal administrators have indicated a willingness to extend the Chinese Wall beyond its present use in preventing information flow between trust and lending departments of a bank.¹⁸⁸ One

594 (3d Cir. 1979). See Mendez-Penate, *supra* note 97, at 687-88. The contention is particularly valid when there is significant incentive for use by the bank. See text accompanying notes 108-11 *supra*.

186. Herzel & Rosenberg, *supra* note 1, at 679-83. See generally Bruzda & Seidel, *Bank Trust Departments and the 10b-5 Dilemma*, 21 VILL. L. REV. 367 (1976); Herman & Safanda, *The Commercial Bank Trust Department*, 14 B.C. IND. & COM. L. REV., 21 (1972); Herzel & Colling, *The Chinese Wall and Conflict of Interest in Banks*, 34 BUS. LAW. 73 (1978); Huck, *The Fatal Lure of the Impermeable Chinese Wall*, 94 BANKING L.J. 100 (1977); Hunsicker, *Conflicts of Interest, Economic Distortions, and the Separation of Trust and Commercial Banking Functions*, 50 S. CAL. L. REV. 611 (1977).

Not everyone who has considered this issue agrees, however. For discussions on the inapplicability of a "Chinese Wall" to all situations, see *Westinghouse Electric Corp. v. Kerr-McGee Corp.*, 580 F.2d 1311 (7th Cir. 1978); *Fund of Funds v. Arthur Anderson Co.*, 567 F.2d 225 (2d Cir. 1977); Slade v. Shearson, Hammill & Co., Inc., [1973-1974 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 94,329 (1974).

187. For specific recommendations on the proper internal procedures to be implemented to guard against liability, see Herzel & Colling, note 186 *supra*, and Herzel & Rosenberg, note 1 *supra*.

188. Both then Federal Reserve Board Chairman G. William Miller and Comptroller of the Currency John G. Heimman indicated in letters to Henry Reuss, Chairman of the House Committee on Banking, Finance and Urban Affairs, that potential conflicts of inter-

federal court has also impliedly recognized the value of a wall in isolating more than the trust department.¹⁸⁹ The Securities and Exchange Commission, in recently adopted rule changes, has also endorsed the application of the Chinese Wall theory to divisions within a multiservice financial institution.¹⁹⁰

Even without such a wall, a bank may be able to show adequately that, under general procedures, it does not inquire into the status of one borrower when evaluating a loan to another customer, and, in the particular loan being questioned, there was not sufficient incentive to justify a presumption of use. In response to a Rule 10b-5 claim, it may also be able to show that most or all of the information it received from the target was publicly available through stockholder reports, investment services, and other non-confidential sources.¹⁹¹ Finally, it may demonstrate that the information on which it based its loan determination would not be material to an investor contemplating the purchase or sale of the target's stock.

IV. CONCLUSION

This Note has presented an analysis of the potential liability of a bank which chooses to finance the hostile takeover of a corporate borrower. It should be apparent that even though a lawsuit which challenges the propriety of such action may be ultimately fruitless, sufficient legal arguments can be made to bring the controversy before the courts. In view of this very real possibility, Judge Gibbon's fear that capital funding may be curtailed is a

est should be avoided. However, application of present federal statutory provisions to the indirect disclosure problem would turn on the definition of what constitutes "recommending" the sale or purchase of securities. See *Legal Times of Washington*, *supra* note 13.

189. The court in *Harnischfeger Corp. v. Paccar, Inc.*, 474 F. Supp. 1151 (E.D. Wis. 1979), recognized the function of a Chinese Wall in finding that no misuse of confidential information had occurred by the fact that a wall had been constructed and was established bank policy.

190. SEC Exchange Act Release No. 17120, 20 SEC DOCKET 1241 (Sept. 16, 1980); See SEC Exchange Act Release No. 16385, 18 SEC DOCKET 1092 (Nov. 29, 1979).

The internal isolation of material, non-public information (the so-called "Chinese Wall") is generally the approach taken in proposed Rule 14e-3(b). Under the proposal, conduct by a person other than a natural person which would, but for [the existence of a wall], violate proposed Rule 14e-3(a), would be deemed non-violative if the [institution] can show that the individuals did not know and did not have access to material non-public information. . . .

Id. at 1100.

191. *Herzel and Rosenberg*, *supra* note 1, at 678-81.

valid concern.¹⁹² The only solution appears to be legislative action on both the state and federal levels which would attempt to sort out the myriad interests and conflicts involved. From its perspective, the Securities and Exchange Commission has recently begun to tackle this problem by proposing legislation which will enable it to regulate the use of confidential information by a bank in these circumstances. Other governmental bodies should be encouraged to follow its lead.¹⁹³

PAUL R. LOVEJOY

192. See text accompanying notes 43-54 *supra*.

193. See Williams Letter, *supra* note 107. In its proposed changes of the federal securities laws, the SEC does not advocate legislation which would impose an absolute prohibition on banks financing tender offers for corporate loan customers. Rather, the Commission asserts that a bidder should be required to disclose the identity of its tender if the bank faces a potential conflict of interest because of its prior or present commercial relationship with the target. *Id.* at 10.