

December 1980

## Caveat Lender - Federal Securities Law Does Not Apply to a Commercial Loan Secured by a Pledge of Securities

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### Recommended Citation

Vincent A. Lavieri, *Caveat Lender - Federal Securities Law Does Not Apply to a Commercial Loan Secured by a Pledge of Securities*, 56 Chi.-Kent L. Rev. 1227 (1980).

Available at: <https://scholarship.kentlaw.iit.edu/cklawreview/vol56/iss4/11>

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CAVEAT LENDER—FEDERAL SECURITIES LAW DOES NOT  
APPLY TO A COMMERCIAL LOAN SECURED BY A  
PLEDGE OF SECURITIES

*Lincoln National Bank v. Herber*

604 F.2d 1039 (7th Cir. 1979)

Prior to the decision of the United States Court of Appeals for the Seventh Circuit in *Lincoln National Bank v. Herber*,<sup>1</sup> three federal circuit courts had considered whether a pledge of securities as collateral for a loan constitutes a “sale” of securities within the meaning of the Securities Act of 1933<sup>2</sup> and the Securities Exchange Act of 1934.<sup>3</sup> The Second and Sixth Circuits<sup>4</sup> determined that such a pledge constituted a “sale” of securities,<sup>5</sup> while the Fifth Circuit reached the opposite conclusion regarding this issue.<sup>6</sup> In a well-reasoned opinion by Senior Circuit Judge Castle, the Seventh Circuit in *Herber* adopted a “context over form” approach which had been formulated by the United States Supreme Court in defining a “security” under the federal securities acts.<sup>7</sup> In utilizing this approach, the Seventh Circuit concluded that a pledge of securities does not constitute a “sale” of securities under the antifraud provisions of the 1933 and 1934 Acts.

This case comment will initially consider the legislative history of the federal securities acts and the United States Supreme Court’s application of that legislative history in prior decisions which are relevant to *Herber*. The facts and holdings of the prior appellate cases which involved the issue decided in *Herber* will be examined. The facts and lower court history of the case and the rationale of the *Herber* court

1. 604 F.2d 1039 (7th Cir. 1979).

2. 15 U.S.C. §§ 77a-77aa (1976) [hereinafter referred to as the 1933 Act].

3. 15 U.S.C. §§ 78a-78kk (1976) [hereinafter referred to as the 1934 Act].

4. See *Mansbach v. Prescott, Ball & Turben*, 598 F.2d 1017 (6th Cir. 1979); *Mallis v. FDIC*, 568 F.2d 824 (2d Cir.), cert. granted, 431 U.S. 928 (1977), cert. dismissed as improvidently granted, 435 U.S. 381 (1978); *United States v. Gentile*, 530 F.2d 461 (2d Cir.), cert. denied, 426 U.S. 936 (1976).

5. Section 77b(3) of the 1933 Act states: “The terms ‘sale’ or ‘sell’ shall include every contract of sale or disposition of a security or interest in a security, for value.” 15 U.S.C. § 77b(3) (1976). Section 78c(a)(14) of the 1934 Act states: “The terms ‘sale’ and ‘sell’ each include any contract to sell or otherwise dispose of.” *Id.* § 78c(a)(14). Unlike the 1933 Act, the 1934 Act also defines the terms “buy” and “purchase” as follows: “The terms ‘buy’ and ‘purchase’ each include any contract to buy, purchase, or otherwise acquire.” *Id.* § 78c(a)(13).

6. See *National Bank of Commerce v. All Am. Assur. Co.*, 583 F.2d 1295 (5th Cir. 1978).

7. See, e.g., *International Bhd. of Teamsters v. Daniel*, 439 U.S. 551 (1979); *United Hous. Found., Inc. v. Forman*, 421 U.S. 837 (1975); *Tcherepnin v. Knight*, 389 U.S. 332 (1967).

will be reviewed. Finally, the *Herber* decision will be analyzed and it will be demonstrated that the Seventh Circuit's decision rests upon sound reasoning and policy considerations.

### THE FEDERAL SECURITIES ACTS: LEGISLATIVE HISTORY AND STATUTORY INTERPRETATION

Congressional activity in the area of securities regulation resulted primarily from the stock market crash of October 1929.<sup>8</sup> Congressional concern about the state of the securities industry in the late 1920's and early 1930's is reflected in the articulated purposes of the two acts. The Securities Act of 1933 was enacted "to provide full and fair disclosure of the character of securities . . . and to prevent frauds in the sale of securities."<sup>9</sup> The Securities Exchange Act of 1934 was designed "to provide for the regulation of securities exchanges and over-the-counter markets . . . and to prevent inequitable and unfair practices on such exchanges and markets."<sup>10</sup> In essence, both acts were designed to eliminate the abuses which had existed in the financial markets and which had contributed to the stock market crash.<sup>11</sup> To oversee the administration and enforcement of the federal securities acts, section 4 of the 1934 Act<sup>12</sup> created the Securities and Exchange Commission.<sup>13</sup>

The underlying purpose of the securities legislation is reflected in the statement of Senator Fletcher, the sponsor of the 1933 Act. Senator Fletcher explained that "the purpose of [the 1933 Act] is to protect the investing public and honest business."<sup>14</sup> The goal of the 1933 Act was "to prevent further exploitation of the public by the sale of unsound, fraudulent, and worthless securities; to place adequate and true information before the investor."<sup>15</sup> Senator Fletcher indicated that the aims of the 1933 Act may be attained "upon the basis of fidelity to truth."<sup>16</sup>

8. I L. LOSS, *SECURITIES REGULATION* 119-21 (2d ed. 1961) [hereinafter cited as Loss]; Landis, *The Legislative History of the Securities Act of 1933*, 28 GEO. WASH. L. REV. 29, 30 (1959).

9. Preamble to the Securities Act of 1933, 15 U.S.C. §§ 77a-77aa (1976).

10. Preamble to the Securities Exchange Act of 1934, 15 U.S.C. §§ 78a-78kk (1976).

11. *United Hous. Found., Inc. v. Forman*, 421 U.S. 837, 849 (1975). See generally James, *The Securities Act of 1933*, 32 MICH. L. REV. 624, 624-30 (1934); Loomis, *The Securities Exchange Act of 1934 and the Investment Advisers Act of 1940*, 28 GEO. WASH. L. REV. 214, 216-17 (1959).

12. 15 U.S.C. § 78d (1976).

13. Hereinafter referred to as the SEC. The 1934 amendments to the 1933 Act transferred the functions originally delegated to the Federal Trade Commission to the newly-created SEC. 15 U.S.C. § 78i (1976).

14. S. REP. NO. 47, 73d Cong., 1st Sess. (1933).

15. *Id.*

16. *Id.* For a comprehensive history of the 1933 and 1934 Acts, see J. ELLENBERGER & E. MAHAR, *LEGISLATIVE HISTORY OF THE SECURITIES ACT OF 1933 AND THE SECURITIES EXCHANGE ACT OF 1934* (1973).

Professor Loss, a noted commentator in the area of securities regulation, stated that the primary purposes of the 1934 Act are four-fold: (1) to provide disclosure to purchasers and sellers of securities; (2) to regulate the securities exchanges and markets; (3) to control the amount of credit in these exchanges and markets; and (4) to present and provide remedies for fraudulent securities transactions and market manipulation.<sup>17</sup> In short, Congress sought to protect the investing public and its interests in the securities market.<sup>18</sup>

In interpreting federal securities law, the United States Supreme Court has favored a flexible approach in order to promote better the underlying investor-oriented purposes of the 1933 and 1934 Acts.<sup>19</sup> At no time has the Court adopted a literal approach to the construction of the two acts.<sup>20</sup> Although the initial focus in construing federal securities law is naturally on the language of the statute itself,<sup>21</sup> the Court has cautioned that "a thing may be within the letter of the statute and yet not within the statute, because not within its spirit, nor within the intention of its makers."<sup>22</sup>

The Supreme Court's desire to interpret the federal securities acts in accordance with congressional intent is reflected in the Court's recognition of private enforcement of section 10(b) of the 1934 Act<sup>23</sup> and rule 10b-5,<sup>24</sup> despite the lack of an express statutory command authorizing such actions.<sup>25</sup> Accordingly, the Court has limited an implied private right of action to situations where the private cause of action is necessary to fulfill congressional goals.<sup>26</sup>

The interpretation of federal securities law also depends upon the economic realities of security transactions; such transactions, after all,

17. Loss, *supra* note 8, at 130-31.

18. See, e.g., *United Hous. Found., Inc. v. Forman*, 421 U.S. 837, 849 (1975).

19. See *International Bhd. of Teamsters v. Daniel*, 439 U.S. 551 (1979); *United Hous. Found., Inc. v. Forman*, 421 U.S. 837 (1975); *Tcherepnin v. Knight*, 389 U.S. 332 (1967).

20. See *Tcherepnin v. Knight*, 389 U.S. 332, 336 (1967).

21. *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 197 (1976).

22. *United Hous. Found., Inc. v. Forman*, 421 U.S. 837, 849 (1975), quoting *Church of the Holy Trinity v. United States*, 143 U.S. 457, 459 (1892).

23. 15 U.S.C. § 78j(b) (1976) [hereinafter referred to in text and footnotes as section 10(b)].

24. 17 C.F.R. § 240.10b-5 (1979) [hereinafter referred to in text and footnotes as rule 10b-5].

25. See *Superintendent of Ins. v. Bankers Life & Cas. Co.*, 404 U.S. 6 (1971).

26. See *Santa Fe Indus. v. Green*, 430 U.S. 462 (1977). In defining the situations in which an implied private right of action exists, the United States Supreme Court has adopted a four-part test applicable to the federal securities acts. The first inquiry is "whether the plaintiff is 'one of the class for whose *especial* benefit the statute was enacted. . . ." Second, it must be ascertained whether there is "any indication of legislative intent, explicit or implicit, to create such a remedy or deny one." The third consideration is "whether it is 'consistent with the underlying scheme to imply such a remedy for the plaintiff.'" Finally, it must be determined "whether the cause of action [is] traditionally relegated to state law. . . ." *Piper v. Chris-Craft Indus.*, 430 U.S. 1, 37-40 (1977), quoting *Cort v. Ash*, 422 U.S. 66, 78 (1975) (emphasis in original).

are economic in nature.<sup>27</sup> The Supreme Court has identified a basic test for distinguishing a securities transaction from other types of commercial transactions. A securities transaction "involves an investment of money in a common enterprise with profits to come solely from the efforts of others."<sup>28</sup> In entering into a securities transaction, the investor hopes to obtain economic benefits through the form of profits.<sup>29</sup>

Since the 1933 and 1934 Acts are remedial in nature, the Supreme Court has sought to interpret the acts as broadly as the statutory language permits in order to carry out the expressed legislative intent.<sup>30</sup> The Supreme Court has chosen to concentrate on the substance of a securities transaction, rather than its form.<sup>31</sup> The basis for this "substance over form" approach is found in the caveat "unless the context otherwise requires"<sup>32</sup> which precedes the definitional sections of the 1933 and 1934 Acts.<sup>33</sup> In applying federal securities law to a particular transaction, the Court has stated "form should be disregarded for substance and the emphasis should be on economic reality."<sup>34</sup> Thus, it is possible to afford broad protection to investors under the two acts by interpreting the acts to cover a variety of investment schemes and contrivances which do not fit neatly within the statutory language.<sup>35</sup> On the other hand, this flexible approach may also exclude those transactions which are described in investment terms but which are not investments in reality and, therefore, not within the intended coverage of federal securities law.<sup>36</sup>

In the final analysis, the interpretation and application of the 1933 and 1934 Acts depend upon two inquiries: first, whether the transaction in question falls within the literal reading of the statute and, second, whether Congress intended for federal securities law to encompass such

27. *United Hous. Found., Inc. v. Forman*, 421 U.S. 837, 849 (1975).

28. *Id.* at 852, quoting *SEC v. W.J. Howey Co.*, 328 U.S. 293, 301 (1946).

29. Profits may include capital appreciation or income derived from the use and development of the investor's contribution to the venture. *United Hous. Found., Inc. v. Forman*, 421 U.S. 837, 852 (1975).

30. *Tcherepnin v. Knight*, 389 U.S. 332, 336 (1967); *SEC v. Joiner Leasing Corp.*, 320 U.S. 344, 350-51 (1943).

31. *United Hous. Found., Inc. v. Forman*, 421 U.S. 837, 852 (1975); *Tcherepnin v. Knight*, 389 U.S. 332, 336 (1967).

32. 15 U.S.C. §§ 77b, 78c (1976).

33. *SEC v. National Sec., Inc.*, 393 U.S. 453, 466 (1969).

34. *United Hous. Found., Inc. v. Forman*, 421 U.S. 837, 848 (1975), quoting *Tcherepnin v. Knight*, 389 U.S. 332, 336 (1967).

35. *SEC v. W.J. Howey Co.*, 328 U.S. 293, 301 (1946).

36. *See, e.g., International Bhd. of Teamsters v. Daniel*, 439 U.S. 551 (1979) (interest in compulsory, non-contributory pension plan not a security despite statutory definition encompassing such a plan); *United Housing Found., Inc. v. Forman*, 421 U.S. 837 (1975) ("shares" of stock entitling holder to lease an apartment not a security despite designation as such).

a transaction. If the answer to either of these inquiries is in the negative, federal securities law does not apply to the transaction.

### THE CONFLICT AMONG THE CIRCUITS

Prior to the Second Circuit's decision in *Securities & Exchange Commission v. Guild Films Co.*,<sup>37</sup> it was generally considered that a pledge of securities as collateral for a loan did not constitute a "sale" of securities under the federal securities acts.<sup>38</sup> In *Guild Films*, two banks jointly made a loan to defendant Roach who controlled a substantial block of unregistered Guild Films stock. The defendant banks were partially secured on the loan by unregistered Guild Films stock. After Roach defaulted on the loan, the banks began to sell the unregistered securities on a stock exchange.<sup>39</sup> The SEC sought an injunction in federal district court to prevent the sale and delivery after sale of the unregistered Guild Films stock unless the securities were first registered as required by the 1933 Act.<sup>40</sup>

In granting the injunction, the district court found that the borrower had purchased and later pledged the securities with the intent that the banks would sell the stock for his benefit.<sup>41</sup> The court found that the borrower was an underwriter under section 2(11) of the 1933 Act<sup>42</sup> because Roach purchased the stock with a view toward distribution of the stock.<sup>43</sup> The district court also found that the banks were underwriters under section 2(11) because they sold the unregistered stock for the benefit of the borrower.<sup>44</sup>

On appeal, the banks asserted that, since they did not purchase the stock as underwriters, they were exempt from the registration provi-

37. 279 F.2d 485 (2d Cir.), *cert. denied*, 364 U.S. 819 (1960).

38. Loss, *supra* note 8, at 517.

39. 279 F.2d at 487-89. The banks initially had difficulty obtaining title to the pledged securities because the transfer agent refused to transfer the pledged stock to the banks because the stock certificates bore a restrictive legend which prohibited the transfer, pledge, or sale of the unregistered securities. The banks succeeded in obtaining an order in state court compelling the transfer of the stock to the banks. *Id.*

40. SEC v. Guild Films Co., 178 F. Supp. 418 (S.D.N.Y. 1959), *aff'd*, 279 F.2d 485 (2d Cir.), *cert. denied*, 364 U.S. 819 (1960).

41. 178 F. Supp. at 424.

42. 15 U.S.C. § 77b(11) (1976).

43. 178 F. Supp. at 424. Section 5(a) of the 1933 Act, 15 U.S.C. § 77e(a) (1976), requires that a registration statement be in effect prior to the sale, or delivery for sale, of a security. Section 4(1) of the 1933 Act, 15 U.S.C. § 77d(1) (1976), makes the requirements of section 5 applicable to underwriters. The district court's finding that the borrower and banks were underwriters meant that they had violated section 5 because there was no registration statement in effect prior to the sale of the securities.

44. 178 F. Supp. at 424.

sions of the 1933 Act.<sup>45</sup> The United States Court of Appeals for the Second Circuit affirmed the lower court's order; however, it took a more expansive view of the issue. The Second Circuit reasoned that the banks were underwriters of the pledged stock because they had purchased the stock by means of a pledge.<sup>46</sup> The Second Circuit in *Guild Films* brought the sale of pledged securities by the pledgee within the registration provisions of the 1933 Act.<sup>47</sup> Unlike the district court, which relied heavily upon the facts of the case, the Second Circuit seemingly enunciated a per se rule requiring compliance with the 1933 Act's registration requirements whenever a pledgee resorts to selling pledged securities to satisfy the underlying debt.<sup>48</sup>

Sixteen years after *Guild Films*, the Second Circuit was confronted with the issue of whether a pledge of securities constitutes a "sale" under the antifraud provisions of the 1933 Act. In *United States v. Gentile*,<sup>49</sup> the defendants were convicted of a scheme which involved the sale and pledge of stock certificates which had been entrusted to them. The defendants had access to blank stock certificates of various companies because one of them was the president of a stock transfer firm. The defendants issued certificates in their own names without authorization from the issuing corporation. They subsequently sold or pledged the securities.<sup>50</sup> Eventually, they were apprehended and charged with violating and conspiring to violate section 17(a) of the 1933 Act.<sup>51</sup>

In affirming their conviction, the Second Circuit determined that a pledge of securities as collateral for a loan was a "disposition of . . . [an] interest in a security for value"<sup>52</sup> and that, therefore, the pledge constituted a "sale"<sup>53</sup> of securities under section 2(3) of the 1933 Act.<sup>54</sup> The court stated that section 2(3) does not require that title pass to

45. 279 F.2d at 489.

46. The Second Circuit relied upon the broadly-worded definition of sale in section 2(3) of the 1933 Act, 15 U.S.C. § 77b(3) (1976), in determining that a pledge of securities constituted a sale. The court had no difficulty in finding that a pledge was a "disposition of a security or interest in a security, for value" under section 2(3). 279 F.2d at 489. The court also noted that Congress rejected a proposed provision to the 1933 Act which would have exempted sales of securities from the registration provisions where the sale was for the purpose of liquidating a bona fide debt. *Id.*, citing S. 875, 73d Cong., 1st Sess. § 126 (1933).

47. 15 U.S.C. §§ 77a-77aa (1976).

48. Compare *Guild Films* with *SEC v. Dolnik*, 501 F.2d 1279 (7th Cir. 1974). *Dolnik* is discussed in the text accompanying notes 119-26 *infra*.

49. 530 F.2d 461 (2d Cir.), *cert. denied*, 426 U.S. 936 (1976).

50. 530 F.2d at 463-64.

51. 15 U.S.C. § 77q(a) (1976) [hereinafter referred to as section 17(a)].

52. 15 U.S.C. § 77b(3) (1976).

53. *Id.*

54. 530 F.2d at 466.

constitute a “sale” and that the defendants’ conduct fell within the strict construction which is applied to criminal statutes.<sup>55</sup> To further support its conclusion, the *Gentile* court reasoned that the result which it reached was implicit in the *Guild Films* decision.<sup>56</sup> The Second Circuit noted that the pledgee, in accepting the securities, “assumes a very real investment risk that the securities will have continuing value, a risk that is identical in nature to the risk taken by investors.”<sup>57</sup> The Second Circuit bolstered its conclusion by relating its decision to the investor-oriented goal of federal securities law.

In *Mallis v. FDIC*,<sup>58</sup> the Second Circuit considered whether a pledge of securities constitutes a “sale” under the antifraud provisions of the 1934 Act. In that case, two dentists made a loan to an attorney to finance the purchase of stock from a third party. Pursuant to the loan agreement, the attorney delivered the securities to the dentists as collateral for the loan. After the attorney defaulted on his obligation to repay the loan, the dentists learned that the stock was worthless.<sup>59</sup> Subsequently, the dentists filed suit alleging, *inter alia*, violations of section 10(b) and rule 10b-5.<sup>60</sup> The district court held that the dentists lacked standing to pursue their claim under the antifraud provisions of the 1934 Act because no “sale” of securities had occurred.<sup>61</sup>

Addressing the issue of whether a “sale” had occurred, the Second Circuit reconsidered its prior decisions in *Guild Films* and *Gentile*. The court noted that *Gentile* had expanded the *Guild Films* concept of “sale” to include a pledge of securities for purposes of section 17(a) of the 1933 Act. The Second Circuit reiterated the investor-oriented goal of the federal securities acts and concluded that there was no sound basis for denominating a pledge as a “sale” for a criminal prosecution<sup>62</sup> but not for a civil action under the antifraud provisions of the 1933 and 1934 Acts.<sup>63</sup> The court held that the acceptance of the pledge of stock

55. *Id.*

56. *Id.* at 467. For a discussion of *Guild Films*, see text accompanying notes 37-48 *supra*.

57. 530 F.2d at 467.

58. 568 F.2d 824 (2d Cir.), *cert. granted*, 431 U.S. 928 (1977), *cert. dismissed as improvidently granted*, 435 U.S. 381 (1978).

59. 568 F.2d at 826. The stock purchased by the attorney had previously been pledged by the seller to Bankers Trust Company as security for a loan. One year prior to the sale of stock to the attorney, the issuing corporation notified Bankers Trust that the seller’s shares had been recalled for cancellation. Therefore, at the time of the sale, the stock was worthless. *Id.*

60. The essence of the dentists’ claim against Bankers Trust was that Bankers Trust made material misrepresentations at the time it released the seller’s stock for transfer to the attorney in violation of section 10(b) and rule 10b-5. *Id.* at 826-27.

61. *Mallis v. FDIC*, 407 F. Supp. 7 (S.D.N.Y. 1976).

62. *United States v. Gentile*, 530 F.2d 461 (2d Cir.), *cert. denied*, 426 U.S. 936 (1976).

63. 568 F.2d at 829.



by the dentists resulted in a "sale" for purposes of section 10(b) and rule 10b-5.<sup>64</sup>

In the year following *Mallis*, however, the same question was answered in the negative by the Fifth Circuit in *National Bank of Commerce v. All American Assurance Co.*<sup>65</sup> In that case, the controlling shareholder of a corporation arranged for the corporation to issue a new class of stock. The newly-created stock was issued without approval of the corporation's directors and was therefore worthless. Plaintiff bank accepted the worthless stock as collateral for a loan made to the controlling shareholder. The issuing corporation was subsequently adjudicated bankrupt and the pledgee bank suffered a \$1.45 million loss on the loan.<sup>66</sup> The bank filed suit alleging violations of the antifraud provisions of the 1933 and 1934 Acts.<sup>67</sup> The district court dismissed the action on jurisdictional grounds because no "sale" of securities had occurred in connection with the alleged fraud.<sup>68</sup>

Prior to considering whether a pledge of securities constitutes a "sale," the Fifth Circuit noted that, although the wording of the definitions of "purchase," "sale," and "security" in the 1933 Act and 1934 Act differ slightly, the terms are functionally equivalent. Since the court found no distinction between the facts of *All American* and those involved in the Second Circuit's decisions in *Gentile* and *Mallis*, it proceeded to examine the rationale of the Second Circuit cases. The Fifth Circuit acknowledged that, as a policy matter, federal securities law could encompass pledges as it certainly does sales and purchases. But the court felt that, in reality, the securities acts do not extend to pledges. The Fifth Circuit did not agree with the Second Circuit's determination that a pledgee takes an investment risk. The court discounted the risk taken by a pledgee because state law provides a pledgee with a remedy on the note against the maker. Thus, federal law was not needed to regulate pledge transactions.<sup>69</sup> The court also noted that the rights and privileges of the parties to a pledge are not affected to the same degree as with a sale of securities.<sup>70</sup> Finally, the court drew an analogy to the

64. The Second Circuit indicated that the release of the pledged securities by Bankers Trust also constituted a "sale" of securities. *Id.* at 830. The court reversed the lower court's dismissal of the action and granted plaintiffs leave to amend their complaint. *Id.*

65. 583 F.2d 1295 (5th Cir. 1978).

66. *Id.* at 1296.

67. The plaintiff bank alleged violations of section 17(a) of the 1933 Act, 15 U.S.C. § 77q(a) (1976), section 10(b) of the 1934 Act, 15 U.S.C. § 78j(b) (1976), and rule 10b-5, 17 C.F.R. § 240.10b-5 (1977).

68. 583 F.2d at 1300.

69. *Id.*

70. The pledgor generally has the right to sell the security subject to the encumbrance, to vote

rationale used by the United States Supreme Court in *Tcherepnin v. Knight*<sup>71</sup> where the Court stated, in defining a "security," "form should be disregarded for substance and the emphasis should be on economic reality."<sup>72</sup> The Fifth Circuit, in affirming the lower court's order dismissing the action, concluded that in this situation the form of the transaction, a collateral loan, also constituted the substance of the transaction.<sup>73</sup>

The Sixth Circuit, in *Mansbach v. Prescott, Ball & Turben*,<sup>74</sup> was the most recent circuit court, prior to the Seventh Circuit in *Herber*, to consider whether a pledge of securities constitutes a sale. Mansbach, an investor, pledged 300 corporate bonds to a securities brokerage firm as collateral for his trading in stock options. When the investor settled his account with the brokerage firm, a dispute arose as to the amount due on the account. The securities firm initially refused to release the pledged bonds until Mansbach executed a release absolving the brokerage firm of any liability. Eventually, the firm released 295 of the 300 pledged bonds to Mansbach. Mansbach subsequently filed suit, alleging violations of section 10(b) and rule 10b-5.<sup>75</sup>

Among the issues which faced the Sixth Circuit on appeal was whether a pledge of securities constitutes a "purchase" or "sale" of securities under section 10(b) and rule 10b-5.<sup>76</sup> After considering the respective merits of *Gentile*,<sup>77</sup> *Mallis*,<sup>78</sup> and *All American*,<sup>79</sup> the court summarily adopted the reasoning of the Second Circuit rather than that of the Fifth Circuit and held that a pledge of securities was a "sale" for purposes of section 10(b) and rule 10b-5. The court also sought to reconcile its position with that of the Fifth Circuit by noting that the pledge of securities was to a broker-dealer, not to a commercial lender, and that the pledge was intended to serve as collateral for secur-

the stock, to receive dividends or interest, and he is liable for any *ad valorem* taxes. The pledgee, on the other hand, can only sell the stock upon the pledgor's default, does not share in the income or appreciation of the security, and has none of the rights afforded shareholders. *Id.*

71. 389 U.S. 332 (1967).

72. *Id.* at 336.

73. 583 F.2d at 1300.

74. 598 F.2d 1017 (6th Cir. 1979). *Mansbach* was decided after briefing and oral argument in *Herber*, but prior to the Seventh Circuit's decision.

75. *Id.* at 1019-21. The investor sought to recover the loss which he incurred due to the alleged wrongful retention of the bonds by the brokerage firm. The loss resulted from a decrease in the market price of the bonds between the time when demand for the bonds was made and the time when the bonds were released and sold. *Id.* at 1021.

76. *Id.* at 1022.

77. See text accompanying notes 49-57 *supra*.

78. See text accompanying notes 58-64 *supra*.

79. See text accompanying notes 65-73 *supra*.

ities transactions, not to secure a commercial loan. The Sixth Circuit further speculated that the impact on the securities industry which the *Mansbach* facts presented did not necessarily preclude the Fifth Circuit from reaching the same conclusion based upon similar facts.<sup>80</sup>

*LINCOLN NATIONAL BANK V. HERBER*

*Facts of the Case*

After experiencing serious financial difficulties, John Lampe, an attorney, conceived a scheme to restore himself to solvency. In July 1972, Lampe established a revocable inter vivos trust at defendant First National Bank of Lake Forest<sup>81</sup> with himself as the trustee and sole income beneficiary. The corpus of the trust consisted of counterfeit securities which Lampe had obtained and which, if legitimate, would have had a market value in excess of three million dollars. Lampe informed defendant Herber, a neighbor and vice president of defendant Bank of Lake Forest, that he recently inherited a substantial legacy from his father and that he planned an attempt at business.<sup>82</sup>

In January 1973, Lampe obtained short-term financing from Bank of Lake Forest to retire a debt incurred in his purchase of a manufacturing business. To secure his obligation to Bank of Lake Forest, Lampe pledged the counterfeit securities which were held in his trust at Bank of Lake Forest. Although Lampe was unable to pay the loan when it matured, he continued his plans for expansion. In September 1973, Lampe arranged to purchase another company with financing from Associates Capital.<sup>83</sup> Associates Capital invited plaintiff Lincoln National Bank<sup>84</sup> to participate in this loan to Lampe. Prior to agreeing to participate in the loan, Lincoln contacted Herber at Bank of Lake Forest as part of its investigation of Lampe. Herber spoke favorably of Lampe and his relationship with Bank of Lake Forest and confirmed that Lampe was wealthy.<sup>85</sup>

In December 1973, Lampe applied directly to Lincoln for a loan which he intended to use to pay down a portion of his debt to Bank of Lake Forest. As security for this loan, Lampe agreed to pledge a por-

80. 598 F.2d at 1028-30.

81. Hereinafter referred to as Bank of Lake Forest.

82. Lincoln Nat'l Bank v. Lampe, No. 75 C 2806, slip op. at 1-2 (N.D. Ill. June 21, 1978) (unpublished opinion).

83. *Id.* at 3-4.

84. Hereinafter referred to as Lincoln.

85. No. 75 C 2806, slip op. at 4-5.

tion of the securities held in trust at Bank of Lake Forest.<sup>86</sup> During Lincoln's credit investigation of Lampe, Lincoln again contacted Herber at Bank of Lake Forest. Herber again told Lincoln that Bank of Lake Forest's relationship with Lampe was satisfactory and that Lampe was the beneficiary of a trust consisting of negotiable securities.

Initially, Lampe and Lincoln agreed that the securities which were to be pledged would be held in an escrow account at Bank of Lake Forest, but Lincoln's counsel subsequently required it to take physical possession of the collateral. This loan to Lampe was the first of a series of loans which Lincoln made to Lampe during the spring and summer of 1974. By September 1974, Lampe's outstanding indebtedness to Lincoln was \$842,000.<sup>87</sup>

Until September 1974, Lampe's relationship with Lincoln was satisfactory and Lincoln's suspicion had not been aroused. In mid-September, however, Lincoln reviewed the Lampe loans and concluded that Lampe's financial position was not favorable. Lincoln, however, did not take any immediate steps to rectify the situation. In late September, Lampe defaulted on the first loan and Lincoln granted Lampe an extension to repay the loan. In November 1974, the entire scheme fell apart when Lampe was arrested by the Federal Bureau of Investigation for counterfeiting securities. Lincoln reduced its claim against Lampe to judgment in state court, but the judgment was uncollectible.<sup>88</sup>

### *The District Court's Holding*

Lincoln subsequently filed suit in federal district court against the solvent defendants, Bank of Lake Forest and Herber, and also against Lampe, alleging violations of section 17(a) of the 1933 Act,<sup>89</sup> section 10(b) of the 1934 Act,<sup>90</sup> and rule 10b-5.<sup>91</sup> The essence of Lincoln's

86. Brief for Appellant at 14-15, *Lincoln Nat'l Bank v. Herber*, 604 F.2d 1039 (7th Cir. 1979).

87. No. 75 C 2806, slip op. at 4-7.

88. *Id.* at 7.

89. Section 17(a) provides:

It shall be unlawful for any person in the offer or sale of any securities by the use of any means or instruments of transportation or communication in interstate commerce or by use of the mails, directly or indirectly—

(1) to employ any device, scheme, or artifice to defraud, or

(2) to obtain money or property by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(3) to engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser.

15 U.S.C. § 77q(a) (1976).

90. Section 10(b) provides:

claims against Herber and Lake Forest was that they failed to inform Lincoln during its investigation of Lampe that Lampe was in default on his obligation to Bank of Lake Forest and that they made material misrepresentations concerning Lampe's financial condition. Lincoln claimed that it was a purchaser of the securities by virtue of its acceptance of the pledge of Lampe's counterfeit securities. In addition, the plaintiff contended that the actions of Bank of Lake Forest and Herber constituted fraud in connection with Lincoln's purchase of the securities in violation of the antifraud provisions of the federal securities acts. Each of the defendants filed motions to dismiss Lincoln's complaint.<sup>92</sup>

One count of Lincoln's complaint alleged a fraudulent loan transaction between Lampe and Lincoln. Lincoln asserted federal jurisdiction by claiming that the promissory notes executed by Lampe were securities under the 1933 and 1934 Acts. The district court found that the promissory notes did not form a basis for exercising federal jurisdiction because the notes were of a commercial rather than an investment nature.<sup>93</sup>

As a second ground for asserting federal jurisdiction, Lincoln claimed that the pledge of securities as collateral for the loans constituted a "sale" of securities. With respect to Lampe, the district court concluded that "mere acceptance of a pledge of stock as collateral for a

It shall be unlawful for any person, directly or indirectly, by use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange—

(b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the [Securities and Exchange] Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

15 U.S.C. § 78j(b) (1976).

91. Rule 10b-5 provides:

It shall be unlawful for any person, directly or indirectly, by use of any means or instrumentality of interstate commerce or of the mails or of any facility of any national securities exchange,

(a) To employ any device, scheme, or artifice to defraud,

(b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading, or

(c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

17 C.F.R. § 240.10b-5 (1974). Rule 10b-5 was adopted by the SEC in 1942 to effectuate the provisions of section 10(b). See SEC Exch. Act Release No. 3230 (May 21, 1942).

92. 414 F. Supp. at 1282. Lincoln also alleged common law fraud against defendants in a pending state claim. *Id.*

93. The district court stated that the critical inquiry was "whether the plaintiffs are simply borrowers in a commercial transaction who are not protected by the 1934 Act or investors in a securities transaction who are protected." *Id.* at 1275, quoting *C.N.S. Enterprises, Inc. v. G. & G. Enterprises, Inc.*, 508 F.2d 1354, 1359 (7th Cir. 1975).

commercial loan transaction does not invoke the protection of federal securities law.”<sup>94</sup> Nevertheless, the court found that Lincoln, in effect, had purchased the counterfeit securities because foreclosure on the loans would be a futile gesture.<sup>95</sup> The district court, however, dismissed Lincoln’s claims against Herber and Bank of Lake Forest and granted the plaintiff leave to amend its complaint.<sup>96</sup> Lincoln subsequently amended its complaint as it pertained to Herber and Bank of Lake Forest, whereupon Herber and Bank of Lake Forest filed motions for summary judgment.

In an unpublished opinion on the motions for summary judgment, the district court concluded that the pledge of securities constituted a forced sale of the securities to Lincoln when Lincoln learned that the loans to Lampe were in default and uncollectible. The court reasoned that foreclosure would be futile since the securities were worthless and held that this “constructive foreclosure” satisfied the “sale” requirement under federal securities law.<sup>97</sup> The district court, however, granted summary judgment for Herber and Bank of Lake Forest because the record failed to establish the liability of Herber or Bank of Lake Forest.<sup>98</sup>

### *The Seventh Circuit’s Decision*

On appeal to the United States Court of Appeals for the Seventh Circuit, Lincoln sought to overturn the lower court’s order granting summary judgment for the solvent defendants Herber and Bank of Lake Forest.<sup>99</sup> The issues presented to the Seventh Circuit were: (1) whether the federal securities law applied to the pledge transaction and (2) whether defendants Herber and Bank of Lake Forest were liable

94. 414 F. Supp. at 1277.

95. *Id.* at 1278. Although not an issue, the district court noted that counterfeit securities are securities within the meaning of the 1933 and 1934 Acts. *Id.* at 1277, following *Seeman v. United States*, 90 F.2d 88, 89 (5th Cir. 1937).

96. The district court dismissed Lincoln’s claims against Herber and Bank of Lake Forest because the complaint failed to specifically inform them of the particular acts of fraud which formed the basis of Lincoln’s claims as required by Federal Rule of Civil Procedure 9(b). 414 F. Supp. at 1278-79.

97. No. 75 C 2806, slip op. at 11. The “constructive foreclosure” reasoning appeared in the district court’s published opinion. 414 F. Supp. at 1278. In his subsequent unpublished opinion, Judge Decker reaffirmed that rationale, noting that the intervening *Gentile* and *Mallis* decisions reaffirmed his prior conclusion that a pledge of securities constituted a “sale.” No. 75 C 2806, slip op. at 11-12.

98. No. 75 C 2806, slip op. at 29-30. The court concluded that there was fraud which was directly related to the value of the stock pledged to Lincoln, but that Herber and Bank of Lake Forest were not responsible for that fraud.

99. Lampe was not a party to the appeal. 604 F.2d at 1039.

under the antifraud provisions of the 1933 and 1934 Acts.<sup>100</sup>

Lincoln advanced two theories to support its contention that federal securities law applied to the pledge transaction. Lincoln first claimed that the promissory notes which evidenced the loans made to Lampe were securities as defined by the 1933 and 1934 Acts. In rejecting this contention, the Seventh Circuit adopted the district court's opinion on this issue<sup>101</sup> and held that promissory notes which are commercial in nature do not form a basis for exercising federal jurisdiction under the securities acts.<sup>102</sup> The second issue of whether the pledge of securities constituted a "sale" within the meaning of the antifraud provisions of the 1933 and 1934 Acts presented a more difficult question to the court.

The Seventh Circuit began its analysis with a review of the language of the pertinent statutes. Although the court recognized that the definition of "sale" in the 1933 Act differed somewhat from the definitions of "sale" and "purchase" in the 1934 Act, Judge Castle chose to interpret the definitions in the same fashion. After concluding that a pledge fell within the broadly-worded definition of "sale" in the securities acts, the court further considered the admonishing provision, "unless the context otherwise requires."<sup>103</sup> The court rejected a literal reading of the federal securities acts and adopted a "context over form" approach in interpreting the 1933 and 1934 Acts. Using this "context over form" approach,<sup>104</sup> Judge Castle analyzed the issue by considering the legislative history of the securities acts and the underlying economic realities of the pledge transaction.<sup>105</sup>

In its review of the legislative history of the two securities acts, the Seventh Circuit stated that the well-established purpose of the securities acts was to protect the investor in his transactions in the securities market and that Congress was concerned with regulating the use of credit only as it relates to transactions in the market. The court concluded that the use of credit by Lampe in a commercial setting was not the sort of transaction which would affect the securities market. The court next reviewed the history of the provisions in the 1933 and 1934 Acts and did not find any evidence to support Lincoln's contention that a pledge fell within the 1933 and 1934 Acts' definition of "sale." The

100. *Id.*

101. *Lincoln Nat'l Bank v. Lampe*, 414 F. Supp. 1270, 1274-76 (N.D. Ill. 1976).

102. 604 F.2d at 1039.

103. 15 U.S.C. §§ 77b, 78c (1976).

104. 604 F.2d at 1041.

105. *Id.* at 1041-42.

court also noted that a pledge was specifically included within the definition of "sale" in the Public Utility Holding Company Act of 1935.<sup>106</sup> This appeared to lend further support to the court's conclusion that Congress, in drafting the 1933 and 1934 Acts, could have included a pledge within the definition of "sale" but declined to do so.<sup>107</sup>

Judge Castle next analyzed the problem in terms of whether the pledge constituted an investment or commercial risk to the pledgee. The court discussed the Second Circuit decisions in *Mallis*<sup>108</sup> and *Gentile*<sup>109</sup> both of which held that a pledgee assumes an investment risk because the pledgee is assuming the risk that the stock will have continuing value. The Seventh Circuit acknowledged that risk was involved but disagreed that it was an investment risk. The court stated that "the risk is taken for the purpose of making a loan, not for the purpose of investing in securities."<sup>110</sup> Although the court found the facts of *Herber* distinguishable from those of *Mallis* and *Gentile*,<sup>111</sup> it disapproved of the overly broad holdings in those cases.<sup>112</sup> In rejecting the literal approach to the 1933 and 1934 Acts taken by the Second Circuit, the court adopted a "context over form" approach which the Supreme Court had utilized in cases which dealt with the interpretation of other sections of the securities acts.<sup>113</sup> The court's holding that a "sale" of securities does not occur at the time the securities are pledged<sup>114</sup> was found to be in accord with the Fifth Circuit's decision in *All American*.<sup>115</sup> Judge Castle recognized that a "sale" could occur where the pledgor defaults and the securities actually are sold, but he ruled that a pledge, without actual foreclosure, is not sufficient to bring the transaction within the antifraud provisions of federal securities law.<sup>116</sup>

106. 15 U.S.C. §§ 79 to 79z-6 (1976). Section 2(23) of the Public Utility Holding Company Act of 1935 defines "sale" or "sell" as including "any sale, disposition by lease, exchange or pledge, or other disposition." 15 U.S.C. § 79b(23) (1976) (emphasis added).

107. 604 F.2d at 1042.

108. See text accompanying notes 58-64 *supra*.

109. See text accompanying notes 49-57 *supra*.

110. 604 F.2d at 1042.

111. *Id.* at 1042-44.

112. *Id.* at 1044.

113. *Id.* at 1041; see text accompanying notes 30-36 *supra*.

114. 604 F.2d at 1044.

115. See text accompanying notes 65-73 *supra*.

116. 604 F.2d at 1044. In affirming the district court's judgment for defendants, the Seventh Circuit found it unnecessary to decide whether Herber and Bank of Lake Forest possessed the requisite scienter to make them liable under the antifraud provisions of the 1933 and 1934 Acts. *Id.* at 1039.



## ANALYSIS

*"Unless the Context Otherwise Requires"*

One aspect of *Herber* which merits attention is the chameleon-like interpretation of a "sale" in the 1933 and 1934 Acts. Under section 2(3) of the 1933 Act, a pledge literally falls within the definition of a "sale" since it is a "disposition of an interest in a security, for value."<sup>117</sup> Likewise, to pledge is to "otherwise dispose of" a security under section 3(14) of the 1934 Act.<sup>118</sup> In *Securities & Exchange Commission v. Dolnik*,<sup>119</sup> the Seventh Circuit had held that a pledge of securities did constitute a "sale" of securities under section 2(3) where a statutory underwriter attempted to distribute unregistered pledged securities.<sup>120</sup> In contrast, the *Herber* court held that a pledge of securities did not constitute a "sale" for purposes of the antifraud provisions of the 1933 and 1934 Acts. The resolution of this apparent inconsistency in defining a "sale" can be explained by reference to the prefatory caution, "unless the context otherwise requires," to the definitional sections of each act.<sup>121</sup> The contextual approach which Congress imparted to the two acts and which the United States Supreme Court has frequently reaffirmed<sup>122</sup> discounts the use of a strictly literal approach to the interpretation of the securities acts.<sup>123</sup>

Another factor which undoubtedly contributed to the Seventh Circuit's variable approach to defining a "sale" in *Dolnik* and *Herber* is that *Dolnik* involved a commercial loan transaction. In *Dolnik*, a determination that a pledge did not constitute a "sale" of securities would have frustrated the primary goal of the 1933 Act.<sup>124</sup> In the latter case, the relationship between the pledge transaction and the underlying purposes of the two securities acts<sup>125</sup> is more attenuated. A third distin-

117. 15 U.S.C. § 77b(3) (1976).

118. *Id.* § 78c(14).

119. 501 F.2d 1279 (7th Cir. 1974). The *Herber* opinion does not mention *Dolnik*.

120. Compare *Dolnik* with *SEC v. Guild Films*, 279 F.2d 485 (2d Cir.), *cert. denied*, 364 U.S. 819 (1960). *Guild Films* is discussed in the text accompanying notes 37-48 *supra*.

121. 15 U.S.C. §§ 77b, 78c (1976).

122. See, e.g., *SEC v. National Sec., Inc.*, 393 U.S. 453, 466 (1969) and cases cited in note 136 *infra*.

123. See text accompanying notes 30-36 *supra*. The United States Supreme Court has noted that only the Second Circuit has taken a literal approach in defining a "security" under the federal securities acts. *United Hous. Found., Inc. v. Forman*, 421 U.S. 837, 849 n.14 (1975).

124. The 1933 Act is primarily concerned with the distribution of securities to the public. Under this act, disclosure of the nature of the offered securities and the parties involved in the distribution of securities is required. In order to satisfy the disclosure requirements, a registration statement containing basic information must be in effect prior to the sale, or delivery for sale, of the securities to the public. 15 U.S.C. §§ 77a-77aa (1976). See *Loss*, *supra* note 8, at 130.

125. See text accompanying notes 8-18 *supra*.

guishing feature is that *Dolnik* involved a suit brought by the SEC, whereas *Herber* involved a suit brought by a private party. In *Dolnik*, the definition of a "sale" was relevant to the scope of the 1933 Act's registration provisions and not to the issue of standing.<sup>126</sup>

When *Herber* and *Dolnik* are considered together, the Seventh Circuit's approach to issues arising under the definitional sections of the 1933 and 1934 Acts results in a case-by-case approach. Non-statutory factors, such as congressional intent behind the two acts, Supreme Court decisions involving similar issues, and a contextual approach to the issues, form the analytical framework within which the Seventh Circuit operates. The mere fact that a pledge falls within the literal definition of a "sale" cannot be dispositive of the issue without further inquiry into non-statutory factors.

### *The Economic Realities of the Pledge Transaction*

The major focus of Judge Castle's opinion was his consideration of the underlying economic realities of the pledge transaction.<sup>127</sup> In considering the "sale" issue, the Seventh Circuit analyzed the issue in terms of whether the pledge constituted an investment risk or a commercial risk. Authority for this investment-commercial dichotomy can be found in various Supreme Court cases in which the Court considered whether a particular device constituted a "security."<sup>128</sup> In determining whether the various devices presented in the cases constituted a "security," the Court looked to whether a device used was an investment vehicle, that is, a "contract or scheme for the placing of capital or laying out of money in a way intended to secure income or profit from its employment."<sup>129</sup> Another factor indicating investment character was that the profit was to be derived from the efforts of persons other than the contributor.<sup>130</sup> The fact that the investment is not speculative and has a value independent of the common enterprise does not place the device outside the coverage of federal securities law.<sup>131</sup> By defini-

126. See *SEC v. National Sec., Inc.*, 393 U.S. 453, 466-67, 467 n.9 (1969).

127. 604 F.2d at 1042-44.

128. See, e.g., *International Bhd. of Teamsters v. Daniel*, 439 U.S. 551 (1979) (interest in compulsory, non-contributory pension plan not a security); *United Hous. Found., Inc. v. Forman*, 421 U.S. 837 (1975) ("shares" of stock entitling holder to lease apartment not a security despite designation as such); *Tcherepnin v. Knight*, 389 U.S. 332 (1967) (withdrawable capital shares of savings and loan association held to be a security); *SEC v. W.J. Howey Co.*, 328 U.S. 293 (1946) ("unit" of citrus grove development held to be a security).

129. *SEC v. W.J. Howey Co.*, 328 U.S. 293, 298 (1946).

130. *Id.* at 298-99.

131. *Id.* at 301.

tion, a purely commercial device would fall outside of the Court's interpretation of a "security" under the "context over form" approach.

In viewing the underlying economic realities of the pledge accepted by Lincoln, it is apparent that Lincoln was concerned with the possible dilution of collateral through the decrease in value of the pledged stock. However, the pledge transaction did not constitute the placing of funds in a venture operated by Lampe for the purposes of reaping profits for Lincoln. Lincoln's only interest in whether Lampe's use of its money resulted in profits to Lampe was Lincoln's concern with whether Lampe would have a source from which to repay the loans. Lincoln's interest in Lampe's profitability was not that of a party who expected to gain an undeterminable share of the profits. Rather, Lincoln expected to be repaid the amount of the loans, with interest. Assurance of repayment by Lampe was in the form of securities which Lincoln held as the pledgee. Lincoln was not an investor in Lampe's venture; it was a commercial lender holding securities as collateral for the loan.

In his discussion of the economic realities of the pledge transaction, however, Judge Castle failed to set forth any criteria by which an investment risk is distinguishable from a commercial risk. The salient aspects of the pledge transaction, however, do offer a basis for distinguishing between the types of risk. The following inquiries are suggested to generate a partial list of distinguishing features:

(1) Whether the party at risk provides the impetus for the transaction. In the investment situation, an investor with financial resources will seek a vehicle through which financial gains can be expected, whereas in the commercial loan situation, the person lacking financial resources will actively seek funds.<sup>132</sup>

(2) Whether the party at risk receives any equity or ownership interest in the venture. In many cases, the investor will become an owner of the venture and may determine who will manage the venture (*e.g.*, common stock), whereas a commercial lender does not receive an ownership interest in the venture and does not have any control over the venture.

(3) Whether the transaction is related to the transaction to the securities industry. If the transaction has a close relationship to the securities industry, it is more likely that federal securities law will be held to govern the transaction.

(4) Whether the party at risk has any control over the extent to

132. C.N.S. Enterprises, Inc. v. G. & G. Enterprises, Inc., 508 F.2d 1354, 1359 (7th Cir. 1975).

which he is at risk. In the investment situation, the investor does not have any effective control over the extent to which he is at risk. Naturally, some investments are less speculative than others, but the only effective control which the investor has over the risk is his decision whether or not to invest. In the case of the commercial lender, the lender can demand sufficient security for the loan and reduce the potential for loss through diligent appraisal of the collateral for the loan. In addition, the commercial lender can require the borrower to furnish additional collateral if the security for the loan becomes insufficient.

(5) Whether there are remedies available to the plaintiff if the venture fails. In an investment context, the failure of the venture results in a loss of all or a substantial portion of his investment. A commercial lender, however, has recourse to the loan collateral and can foreclose on the collateral if a default occurs.

### *Some Policy Considerations*

The Seventh Circuit's inquiry into the applicability of federal securities law to the pledge of counterfeit securities resulted in a determination of whether Lincoln had standing to pursue its claim under the antifraud provisions of the securities acts. Since only actual purchasers and sellers have standing to prosecute a private action for a violation of the antifraud provisions of the securities acts,<sup>133</sup> Lincoln's failure to show that it acquired the securities by means of a "sale" precluded it from proving the alleged fraud of Herber and Bank of Lake Forest. By declining to permit a "sale" to encompass pledge transactions, the Seventh Circuit has insulated certain federal defendants from federal liability and denied a prospective class of plaintiffs a federal remedy.

Nevertheless, the court's concern about the expansion of federal securities law into a potentially troublesome area is reflected in the court's express rejection of the district court's doctrine of "constructive foreclosure,"<sup>134</sup> although it avoided the issue of whether a "sale" occurs upon actual foreclosure.<sup>135</sup> It is apparent that the Seventh Circuit is

133. This rule as first enunciated in *Birnbaum v. Newport Steel*, 193 F.2d 461 (2d Cir.), *cert. denied*, 343 U.S. 956 (1952), limits standing to pursue a private remedy under section 10(b) and rule 10b-5 to only those persons who are actual, rather than prospective, purchasers and sellers. The United States Supreme Court approved the *Birnbaum* rule in *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 749 (1975).

134. The essence of the "constructive foreclosure" doctrine is that, since the counterfeit securities were worthless, the act of foreclosing on the loan would be a futile gesture. Since the law does not require a party to perform useless acts, the district court treated the loan as having been foreclosed upon by Lincoln. *Lincoln Nat'l Bank v. Lampe*, 414 F. Supp. 1270, 1278 (N.D. Ill. 1976).

135. 604 F.2d at 1044.

unwilling to expand the coverage of federal securities law into the realm of legal fiction. This is founded upon sound policy considerations since it is conceivable that lower courts could fashion other legal fictions to provide a remedy under federal securities law. Through its rejection of the "constructive foreclosure" doctrine and, by implication, other legal fictions, the Seventh Circuit is avoiding the potential dangers which might result from an expansion of the class of plaintiffs who have standing to pursue private causes of action under the federal securities acts.

The Seventh Circuit's decision is in accord with recent United States Supreme Court cases which have limited the scope and coverage of the federal securities acts.<sup>136</sup> In each of these cases, the Court has limited the rights and remedies of the private-party plaintiff under the federal securities acts.<sup>137</sup> One commentator noting this trend stated that "[t]here can be little doubt about the intensity of the Court's concern over the expansion of securities liability and its determination to curb that expansion."<sup>138</sup>

One final consideration which also militates against finding an implied right of action for the injured pledgee of securities is that state remedies are readily available. A defrauded pledgee of securities can pursue its claim under the state common law of fraud. In addition, Articles 8 and 9 of the Uniform Commercial Code regulate the transfer of investment securities and security interests in instruments,<sup>139</sup> respectively, and would be applicable to the pledge of securities.<sup>140</sup> There-

136. *Touche Ross & Co. v. Redington*, 442 U.S. 560 (1979) (section 17(a) of the 1934 Act requiring broker-dealers to keep certain records and to file periodic reports as prescribed by the SEC does not create an implied private right of action); *International Bhd. of Teamsters v. Daniel*, 439 U.S. 551 (1979) (interest in compulsory, non-contributory pension plan not a security); *Santa Fe Indus. v. Green*, 430 U.S. 462 (1977) (fraud under section 10(b) must be manipulative or deceptive to be actionable); *Piper v. Chris-Craft Indus.*, 430 U.S. 1 (1977) (section 14(e) of the 1934 Act does not create an implied private cause of action in a defeated tender offeror); *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976) (scienter, not mere negligence, is a requisite element of a claim under section 10(b) of the 1934 Act); *Rondeau v. Mosinee Paper Co.*, 422 U.S. 49 (1975) (traditional showing for injunctive relief applies to implied causes of action under the federal securities acts); *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723 (1975) (standing under section 10(b) of the 1934 Act is limited to actual purchasers or sellers); *Securities Investor Protection Corp. v. Barbour*, 421 U.S. 412 (1975) (no implied private cause of action under the Securities Investor Protection Act of 1970).

137. *See O'Brien v. Continental Ill. Nat'l Bank & Trust, Co.*, 593 F.2d 54, 62 n.13 (7th Cir. 1979).

138. 4 A. BROMBERG, *SECURITIES LAW, FRAUD, SEC RULE 10B-5* § 384.2 (1977).

139. U.C.C. §§ 8-101 to 8-407, 9-101 to 9-507 (1978).

140. In *Herber*, the Seventh Circuit considered the applicability of the Uniform Commercial Code to the pledge transaction and concluded that Lincoln could pursue its claim under the Illinois codification of the U.C.C., ILL. REV. STAT. ch. 26, §§ 8-101 to 8-407, 9-101 to 9-507 (1977 & Supp. 1978). 604 F.2d at 1044.

fore, the denial of a federal remedy under federal securities law in no way bars a plaintiff, such as Lincoln, from seeking alternate remedies.

#### CONCLUSION

In *Lincoln National Bank v. Herber*, the United States Court of Appeals for the Seventh Circuit held that a pledge of securities as collateral for a commercial loan did not constitute a "sale" of securities for purposes of the antifraud provisions of the Securities Act of 1933 and the Securities Exchange Act of 1934. The court based its conclusion upon a careful reading of the definitional sections of the 1933 and 1934 Acts in conjunction with the legislative history and congressional purpose behind the two acts.

Recent decisions of the United States Supreme Court have limited the expansion of the scope and coverage of federal securities law. The Seventh Circuit's decision in *Lincoln National Bank v. Herber* is in accord with these recent Supreme Court cases and reflects the Supreme Court's concern with the unwarranted expansion of the scope of federal securities law.

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