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COMMENTARY

Lender Liability for Securities Law Violations of Its Borrowers

With increasing frequency, financial institutions that have extended credit to borrowers engaged in the sale of securities have become favorite liability targets for malcontented investors seeking to recoup losses occasioned by the borrowers' violations of the securities acts of 1933 and 1934.¹ This commentary discusses whether a lender who is implicated with a borrower by virtue of a legitimate financial transaction should be held liable for the federal securities law violations of that borrower.

Lender counsel justifiably fear that the investor protection policy that promoted federal securities legislation is becoming mutated into an insurance policy. Judicial construction and application of the securities laws to secondary defendants is confused, nonuniform, and unpredictable. Presently, it is virtually impossible for counsel to advise financial institutions whether the legitimate business relationship between the lender and its borrower is cause to expose the lender to liability for the borrower's violations of the securities acts.²

The introductory sections of this comment summarize the statutory authority and case law interpretations upon which plaintiffs suing financial institutions tend to rely. "Seller" status under section 12(2) of the Securities Act of 1933³ (1933 Act) and "controlling person" liability, provided in section 15⁴ of the 1933 Act and section 20(a)⁵ of the Securities Exchange Act of 1934 (1934 Act), are the first two topics discussed. The succeeding por-

1. See Jones, *Berry Drilling Program Investors File \$9 Million Federal Lawsuit*, The Daily Oklahoman, Nov. 1, 1983. ("Alleging fraud and violations of state and federal securities laws, 37 disgruntled oil and gas investors lodged a \$9 million federal lawsuit Monday against 27 defendants including Utica National Bank & Trust Co. of Tulsa. . ."). See also Wright v. Schock, 571 F. Supp. 642 (N.D. Cal. 1983), *aff'd*, 742 F.2d 541 (9th Cir. 1984); *In re Longhorn Sec. Litig.*, 573 F. Supp. 274 (W.D. Okla. 1983); Wurzburg v. Cornelius, Nos. 83 Civ. 0628 (PNL), 83 Civ. 0794 (PNL); 83-0589 (JRx) (S.D.N.Y., July 19, 1982); *In re Longhorn Sec. Litig.*, No. 525, slip op. (J.P.M.D.L., Dec. 23, 1982).

2. See *Ultramares Corp. v. Touche*, 255 N.Y. 170, 174 N.E. 441 (1931). Chief Justice Cardozo remarked: "The hazards of a business conducted on these terms are so extreme as to enkindle doubt whether a flaw may not exist in the implication of a duty that exposes to these consequences." *Id.* at 179-80, 174 N.E. at 444.

3. 15 U.S.C. § 77i (1982) (section 12(2) of the Securities Act of 1933). See also Silverstein, *Seller Liability under Section 12(2) of the Securities Act of 1933: A Proximate Cause-Substantial Factor Approach Limited by a Duty of Inquiry*, 36 VAND. L. REV. 361 (1983).

4. 15 U.S.C. § 77o (1982) (section 15 of the Securities Act of 1933).

5. 15 U.S.C. § 78T(a) (1982) (section 20(a) of the Securities Exchange Act of 1934).

tions review section 17(a),⁶ section 10(b),⁷ and rule 10b-5⁸ prohibitions against fraud, misrepresentation, deceptive practices, and duty to disclose. The remaining introductory materials discuss the common law doctrines of aider and abettor and respondeat superior as asserted by plaintiffs independently and intermixed with the foregoing statutory provisions.

Following the introductory sections, this commentary provides discussion and examples of cases where lenders have been joined as defendants by reason of their business relationship with the borrower-securities law violator. Thereafter substantial attention will be devoted to the recent case of *Wright v. Schock*.⁹ *Wright* is important not only because summary judgment was entered for the defendant banks but also for the manner and certainty with which the court came to its decision. The remainder of this commentary combines criticism of the theoretical justification for holding lenders liable for the securities law violations of their borrowers and notes the adverse practical impact of such proposed liability.

I. "Seller" Liability Under Section 12(2) of the Securities Act of 1933

The primary goal of the 1933 Act was to assure full disclosure of all material facts relevant to the issuance of new securities, thereby justifying reliance on that information by investors and restoring public confidence in the investment market.¹⁰ This substantial obligation placed on the seller of a security is reflected in the statutory provisions of the 1933 Act.

6. 15 U.S.C. § 77q (1982).

7. 15 U.S.C. § 78j(b) (1982).

8. 17 C.F.R. § 240.10b-5 (1984).

9. 571 F. Supp. 642 (N.D. Cal. 1983), *aff'd*, 742 F.2d 541 (9th Cir. 1984).

10. S. REP. No. 47, 73d Cong., 1st Sess. (1933). Mr. Fletcher from the Committee on Banking and Currency offered:

The purpose of this bill is to protect the investing public and honest business. The basic policy is that of informing the investor of the facts concerning securities to be offered for sale in interstate commerce, and providing protection against fraud and misrepresentation.

The aim is to prevent further exploitation of the public by the sale of unsound, fraudulent, and worthless securities through misrepresentation; to place adequate and true information before the investor; to protect honest enterprise, seeking capital by honest presentation, against the competition afforded by dishonest securities offered to the public through crooked promotion. . . .

See also, H.R. REP. No. 4314, 73d Cong., 1st Sess. § 6 (1933):

There is, however, an obligation upon us to insist that every issue of new securities to be sold in interstate commerce shall be accompanied by full publicity and information, and that no essentially important element attending the issue shall be concealed from the buying public.

This proposal adds to the ancient rule of caveat emptor, the further doctrine "let the seller also beware." It puts the burden of telling the whole truth on the seller. It should give impetus to honest dealing in securities and thereby bring back public confidence.

The purpose of the legislation I suggest is to protect the public with the least possible interference to honest business.

Franklin D. Roosevelt (emphasis added).

Section 12(2) protects the purchaser of a security from persons who offer or sell securities by means of untrue statements or omissions of material facts. The plain import of the language in the statute indicates that the remedy is intended to reach the person from whom the defrauded purchaser bought his securities. Unless the seller can prove that he did not know and in the exercise of reasonable care could not have known of such untruth or omission, that seller will be primarily liable to the purchaser for the consideration paid for the security, with interest, less the amount of any income received, or for damages if he no longer owns the security.

Lenders dealing with their customers in the traditional manner, that of a pure lender-borrower relationship, should not fall within the definition of a seller, absent certain qualifying circumstances as discussed below. Financial institutions, however, may not be completely shielded from seller status if the lender's relationship with its borrower proves to be a proximate cause or a substantial factor in the illegal distribution of securities.¹¹

As a prerequisite to recovery under section 12(2), strict privity between the seller and the purchaser has been held a staunch requirement in some courts.¹² Both a broker and a seller can be held liable under section 12(2) where the broker acts as an agent for the seller. Further, the plaintiff need not identify in his complaint the particular seller from whom he purchased his securities where the principal has concealed his identity.¹³ Similarly, the specification of particular defendants from whom each plaintiff purchased securities may not be required when the complaint alleges a conspiracy among persons in control of the direct seller who allegedly violated the securities law.¹⁴ Nevertheless, at times, strict privity between the buyer and the immediate seller has been required despite allegations in the complaint that there was a conspiracy among the defendants.¹⁵

In *McFarland v. Memorex Corporation*¹⁶ the plaintiff alleged causes of

11. Silverstein, *supra* note 3, at 370: "Rejecting the strict privity, participation and duty approaches, many courts employ a proximate causation test to delineate the scope of Section 12(2) seller liability." *Wonneman v. Stratford Sec. Co.*, [1961-1964 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 90,923 (S.D.N.Y. 1959) was one of the first cases to apply this test. *See, e.g., Junker v. Cory*, 650 F.2d 1349 (5th Cir. 1981); *Croy v. Campbell*, 624 F.2d 709 (5th Cir. 1980); *Pharo v. Smith*, 621 F.2d 656 (5th Cir. 1980); *Hill York Corp. v. American Int'l Franchises, Inc.*, 448 F.2d 680 (5th Cir. 1971); *Lennerth v. Mendenhall*, 234 F. Supp. 59 (N.D. Ohio, 1964).

12. *Sanders v. John Nuveen & Co.*, 619 F.2d 1222, 1226 (7th Cir. 1980), *cert. denied*, 450 U.S. 1005 (1981); *Collins v. Signetics Corp.*, 605 F.2d 110, 113 (3d Cir. 1979); *Cady v. Murphy*, 113 F.2d 988 (1st Cir.), *cert. denied*, 311 U.S. 705 (1940) (only seller as title holder or broker-agent of seller can be in privity with the purchaser); *Kramer v. Scientific Control Corp.*, 452 F. Supp. 812 (E.D. Pa. 1978); *Brick v. Dominion Mort. & Realty Trust*, 442 F. Supp. 283 (W.D.N.Y. 1977); *Dorfman v. First Boston Corp.*, 336 F. Supp. 1089 (E.D. Pa. 1972). *But see McFarland v. Memorex Corp.* [1983-1984 Transfer Binder] FED. SEC. L. REP. ¶ 99,635 (N.D. Cal. 1984).

13. *Buckholtz v. Renard*, 188 F. Supp. 888 (S.D.N.Y. 1960).

14. *Bailey v. Huntington Sec. Co.*, 35 F.R.D. 169 (S.D.N.Y. 1963).

15. *Kramer v. Scientific Control Corp.*, 452 F. Supp. 812 (E.D. Pa. 1978).

16. 493 F. Supp. 631 (N.D. Cal. 1980).

action based on section 12(2), among others, in connection with a transaction involving the offer and sale of shares of common stock of Memorex Corporation. The plaintiff's complaint stated that each defendant was sued both individually, as a coconspirator, and as an aider and abettor. Also, with respect to certain defendants, the complaint contained allegations of a control relationship.

The court in *McFarland* granted the defendants' motion to dismiss the plaintiff's section 12(2) claim because the plaintiff failed to allege that he purchased his stock from any of the moving defendants. The court adopted a literal interpretation of section 12(2), rejected an expansive view of the statutory term "seller," and stated:

[T]he Court recognize[s] that a literal reading has not been adopted by all courts. Even under a broader standard, however, a mere allegation of co-conspiracy or of aiding and abetting will not suffice. Congressional intent is paramount in interpreting the reach of the statute. If it appears that Congress intended to place certain limits on liability, as here where it made only sellers liable, then those limits cannot be ignored by resort to theories of conspiracy or aiding and abetting.¹⁷

As indicated in *McFarland*, however, not all courts regard strict privity as an absolute prerequisite to liability under section 12(2).¹⁸

A participation theory¹⁹ and/or a duty²⁰ approach have been offered as means to avoid the strict privity requirement. Numerically, however, the "proximate cause—substantial factor" line of cases dominates seller status analysis. Plaintiffs are more likely to be successful using these theories than the strict privity approach for extension of liability to lenders when the lender's customers are the contractual sellers of the securities.²¹

The substantial factor approach was espoused in *Hill York Corp. v. American International Franchises, Inc.*²² According to *Hill York*, a determination

17. *Id.* at 647, citing *In re Equity Funding Corp. of Am. Sec. Litig.*, 416 F. Supp. 161, 181 (C.D. Cal. 1976).

18. The Court in *McFarland* recently granted a motion to reconsider the plaintiffs' section 12(2) claims because the definition of seller has been judicially broadened to include persons whose participation in the securities transaction directly and proximately caused an investor's injury. 581 F. Supp. 878 (N.D. Cal. 1984). See also Silverstein, *supra* note 3, at 367.

19. *In re Home-Stake Prod. Co. Sec. Litig.*, 76 F.R.D. 337 (N.D. Okla. 1975); *Freed v Szabo Food Serv., Inc.*, [1961-1964 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 91,317 (N.D. Ill. 1964).

20. *Gould v. Tricon, Inc.*, 272 F. Supp. 385 (S.D.N.Y. 1967).

21. Silverstein, *supra* note 3, at 368-69.

22. 448 F.2d 680, 692 (5th Cir. 1971). See also *Stokes v. Lokken*, 644 F.2d 779 (8th Cir. 1981); *Croy v. Campbell*, 624 F.2d 709 (5th Cir. 1980) (a tax adviser who made no representations concerning any of the operational or construction aspects of the project in which his clients invested, delivered a brochure to the clients on behalf of the clients but not on behalf of the general partner of the project, did not attempt to persuade the clients that they should purchase an interest in the project, and referred to the project as the best investment they could make from a tax standpoint, was not a seller of a security).

that one participated in the sales transaction is not conclusive as to that participant's liability as a seller. The Fifth Circuit stated in *Pharo v. Smith*²³ that *Hill York* and *Lewis v. Walston & Co.*²⁴ limit the definition of sellers under section 12(2) to (1) those in privity with the purchaser and (2) those whose participation in the transaction is a substantial factor in causing the transaction to take place. "*Mere participation in the events leading up to the transaction is not enough.*"²⁵

A lender's participation in the promotion and sale of its customer's securities to the extent necessary to fall within the holdings above is conceivable. However, the emphasis should be placed on the fact that "[t]he test is whether the injury to the plaintiff flowed directly from the defendant."²⁶

Courts understandably seem reluctant to expand the scope of seller status. "A review of the substantial factor cases shows that a much greater degree of involvement is necessary to establish section 12 liability than simply the provision of routine though necessary services. . . ."²⁷ Moreover, courts have found section 12 inapplicable to persons much more directly involved in transactions than banks and title companies.²⁸ Although the United States Supreme Court has yet to speak on the scope of seller status under section 12(2), the trend is to return to a strict privity approach.²⁹ Presently, more than mere participation but less than strict privity seems to be the balance of the law.³⁰

23. 621 F.2d 656 (5th Cir.), *reh'g granted, remanded*, 625 F.2d 1226 (1980).

24. 487 F.2d 617 (5th Cir. 1977).

25. *Pharo v. Smith*, 621 F.2d 656, 667 (5th Cir.), *reh'g granted, remanded*, 625 F.2d 1226 (1980) (emphasis added).

26. *Admiralty Fund v. Jones*, 677 F.2d 1289 (9th Cir. 1982). The court also dropped a footnote following its remark:

Note that the broad reading of 'seller' may be in some doubt in light of recent Supreme Court cases that prescribe a strict statutory construction approach to the securities acts and reject their expansion with tort and criminal theories. See *Admiralty Fund v. Hugh Johnson & Co.*, 677 F.2d 1301, 1311 n.12 (9th Cir. 1982).

27. *Wright v. Schock*, 571 F. Supp. 642, 657 (N.D. Cal. 1983), *aff'd*, 742 F.2d 541 (9th Cir. 1984), *citing* *Admiralty Fund v. Jones*, 677 F.2d 1289 (9th Cir. 1982); *SEC v. Murphy*, 626 F.2d 633 (9th Cir. 1980); *Hill York Corp. v. American Int'l Franchises, Inc.*, 448 F.2d 680 (5th Cir. 1972). See also *Montgomery v. Batt*, [1983-1984 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 99,647 (N.D. Cal. 1984).

28. *Wright v. Schock*, 571 F. Supp. 642, 657 (N.D. Cal. 1983), *aff'd*, 742 F.2d 541 (9th Cir. 1984).

29. Silverstein, *supra* note 3, at 381.

30. *Hill York Corp. v. American Int'l Franchises, Inc.*, 448 F.2d 680 (5th Cir. 1971); *Katz v. Amos Treat & Co.*, 411 F.2d 1046 (2d Cir. 1969); *Woods v. Homes & Structures, Inc.*, 489 F. Supp. 1270 (D. Kan. 1980), *citing* *Lewis v. Walston & Co.*, 487 F.2d 617 (5th Cir. 1973); *Plunkett v. Francisco*, 430 F. Supp. 235 (N.D. Ga. 1977); *Stern v. American Bankshares Corp.*, 429 F. Supp. 818 (E.D. Wis. 1977); *Hoglund v. Covington County Bank*, [1977-1978 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,003 (M.D. Ala. 1977); *In re Home-Stake Prod. Co. Sec. Litig.*, 76 F.R.D. 337 (N.D. Okla. 1975); *In re Caesar's Palace Sec. Litig.*, 360 F. Supp. 366 (S.D.N.Y. 1973); *duPont v. Wyly*, 61 F.R.D. 615 (D. Del. 1973); *Brick v. Dominion Mort. & Realty Trust*, 442 F. Supp. 283 (W.D.N.Y. 1977). See also *supra* note 16, and accompanying text.

Rarely do plaintiffs solely allege violations of section 12(2); most often the complaints also assert violations of section 17(a) of the 1933 Act³¹ and both section 10(b) of the 1934 Act and rule 10b-5.³² Although lenders may not be found primarily liable under these provisions, it is arguable that the controlling person provisions of the securities acts can subject lenders to secondary liability for securities violations.

II. "Controlling Person" Liability

Section 15 and Section 20(a)

Section 15 of the 1933 Act creates joint and several liability for every person who *controls* anyone liable under certain enumerated sections.³³ Ostensibly, a lender may face exposure to secondary liability under section 15 if its customer has made false registration statements,³⁴ or has provided either untrue or misstated information in prospectuses or oral communication, or has omitted material facts therefrom.³⁵ The sole defense to section 15 secondary liability is proof that the controlling person had no knowledge or reasonable grounds to believe in the existence of facts by which the liability of the controlled person is alleged to exist.

A plaintiff alleging section 15 secondary liability for a lender must prove a primary violation of at least one of the enumerated securities act sections and that the lender controlled its borrower to the extent required to bring the lender within the terms of the section. Thereafter, the burden shifts to the lender to establish what is, in essence, a defense of ignorance. The controlling person section of the 1934 Act resembles section 15 of the 1933 Act but adds a provision for indirect control and alters the defense somewhat.³⁶ Good faith and freedom from having induced, directly or indirectly, the acts constituting the securities violation will protect the controlling person.

What constitutes control for purposes of section 15 and section 20(a) is discussed in the following section. The conflict between the commercial necessity that a lender acquire sufficient knowledge about the business practices of its borrower to justify extending credit to that borrower and the resulting difficulty in establishing a section 15 defense is discussed in part VII.

Determining Control

Neither section 15 nor section 20 define the term "control." This omission was deliberate on the part of the drafters and was left to judicial interpretation.³⁷ However, the Securities Exchange Commission has supplemented

31. 15 U.S.C. § 77q (1982).

32. 15 U.S.C. § 78j, (b) (1982) and 17 C.F.R. § 240.10b-5 (1984), respectively.

33. 15 U.S.C. § 77o (1982).

34. 15 U.S.C. § 77k (1982).

35. 15 U.S.C. § 77l (1982).

36. 15 U.S.C. § 78t (1982).

37. H.R. REP. No. 1383, 73d Cong., 2d Sess. 26 (1934):

It was thought undesirable to attempt to define the term [control]. It would be

the statutory language with its own definition: "The term 'control' (including the terms 'controlling,' 'controlled by' 'and under common control with') means the possession, direct or indirect, of the power to direct or cause the direction of the management and policies of a person, whether through the ownership of voting securities, by contract or otherwise."³⁸ At least two phrases have been used by courts to distinguish types of control: control by status and actual control.

Control by status concerns one's formal position of control over the actions of the primary violator. Hierarchical structures of authority are the most common examples. By this theory, superiors in authority may have to answer for the securities violations of their inferiors. Interlocking directorships, stock ownership, alone or combined with other influences, or agency relationship may or may not suffice to meet the formal control-by-status standard.³⁹

difficult if not impossible to enumerate or to anticipate the many ways in which actual control may be exerted. A few examples of the methods used are stock ownership, lease, contract, and agency. It is well known that actual control sometimes may be exerted through ownership of much less than a majority of the stock of a corporation either by the ownership of such stock alone or through such ownership in combination with other factors.

38. 17 C.F.R. § 230.405(f) (1984). See also Bartlett & Lapatin, *The Status of a Creditor as a "Controlling Person,"* 28 MERCER L. REV. 639 (1977).

39. See, e.g. Richardson v. MacArthur, 451 F.2d 35 (10th Cir. 1971) (where a paid corporate employee charged with developing the corporation in California defrauded Richardson, the corporation was held to be a "controlling person" under the 1934 Act and was liable to the buyer for any fraud perpetrated by the employee); Myzel v. Fields, 386 F.2d 718 (8th Cir. 1967), cert. denied, 390 U.S. 951 (1968). See also SEC v. Management Dynamics, Inc., 515 F.2d 801 (2d Cir. 1975); Moerman v. Zipco, Inc., 302 F. Supp. 439 (E.D.N.Y. 1969), *aff'd*, 422 F.2d 871 (2d Cir. 1970). Cf. Strong v. France, 474 F.2d 747 (9th Cir. 1973); Marshall, *Control Person Liability*, 13 REV. SEC. REG. 927 (1980).

When employing Section 20(a), the federal courts must first ascertain whether or not a defendant is in fact a control person. This determination is an important aspect of 20(a) litigation. It is submitted that the requirement of actual control by the person in question, coupled with a rebuttable presumption of control established by the institutional status of the person, is the most accurate determination of control. An individual's institutional status may act as a warning signal if such a position is normally perceived as one of control. This warning signal will create a rebuttable presumption of control, requiring the defendant to show that he did not possess actual control. Actual control is a necessary element in establishing liability because before a person can exercise control it must be determined that he had actual control.

Id. at 933; Comment, *A Comparison of Control Person Liability and Respondeat Superior: § 20(a) of the Securities Exchange Act of 1934*, 15 CAL. W.L. REV. 154 (1979). See also Ruder, *Multiple Defendants in Securities Laws Fraud Cases: Aiding and Abetting, Conspiracy, In Pari Delicto, Indemnification, and Contribution*, 120 U. PA. L. REV. 597, 605 (1972) (emphasis added):

Unless the agency relationship exists, agency theory cannot be utilized. As a result, plaintiffs will often find it difficult to use agency theory. If the many possible secondary defendants, such as *banks*, accountants, lawyers and others, have neither agreed to act for the primary wrongdoer nor agreed that he may act for them, the search for a so-called "deep-pocket defendant" in the securities law field will turn to other theories.

Actual control (direct or indirect under the 1934 Act) requires more than a showing of mere status, more than just the authority to control. Actual control must have been exercised and have been directly related to the transaction in question.⁴⁰

Control person liability cannot be judged in a vacuum. Its existence is predicated upon a finding of primary liability for securities violations. Although a lender may not have conducted its affairs in a manner justifying the lender's qualification as a seller, section 15 may create responsibility where the lender did or could have controlled the party primarily liable under section 12(2). Such determination is a fact question and almost any conceivable relationship serving as a conduit for control may suffice. The defense in the statute of lack of knowledge or reasonable ground to believe precludes strict liability. Unlike the common law theory of respondeat superior, section 15 seemingly denies strict liability based on status control alone.⁴¹ The quality and quantity of knowledge that would infect the lender to the degree that the lender's reliance on the defense would be unavailable is a subject discussed extensively *infra*.

Section 20 of the 1934 Act provides a good faith defense against control person liability that is broader than the section 15 defense, appropriately counterbalancing the more inclusive scope of the statute itself. Demonstration of good faith⁴² and proof that the defendant did not directly or indirectly induce the violation will cut off liability.

Limitation by the Supreme Court in *Ernst & Ernst v. Hochfelder*⁴³ of primary liability under section 10(b) and rule 10b-5 to knowing or intentional misconduct (scienter, used herein, means intent to deceive, manipulate, or defraud), suggests a similar restriction of the scope of secondary liability under section 20(a) of the 1934 Act.⁴⁴

40. Marshall, *supra* note 39, quoting from *Stern v. American Bankshares Corp.*, FED. SEC. REG. (CCH) ¶ 96,033 (E.D. Wis. 1977). In *Christoffel v. E.F. Hutton & Co.*, 588 F.2d 665, 668 (9th Cir. 1978), the court stated: "Although the concept of 'control' used in section 20(a) is broad, it is not unlimited. The term was not used by Congress as it is defined within the context of common law agency."

41. *Lake v. Kidder, Peabody & Co.*, [1978 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,509 (N.D. Ind. 1978) (a brokerage firm was not liable as a controlling person for the acts of its employee in arranging a private transaction with a customer), *citing* *Ernst & Ernst v. Hochfelder*. 425 U.S. 185 (1976):

A significant aspect of "control person liability" is that it is clearly *not* the absolute liability of common law respondeat superior. . . . As with the scienter requirement itself, the implied causes of action should not saddle absolute vicarious liability upon those lacking scienter and who were not related to the transaction simply under the "control person" rubric, to do so improperly connects the imputed liability concept of control persons with the clearly uncontrolled wrongful actor whose conduct may merit implied liabilities. . . .

Lake v. Kidder, supra at 93,977. *See also* *Clark v. Cameron-Brown Co.*, [1980 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 97,539 (N.D.N.C. 1980).

42. For a discussion of the term "good faith," *see* Comment, *supra* note 39, at 163.

43. 425 U.S. 185 (1976).

44. *Id.* at 193.

Complaints asserting that lenders were controlling persons and thus liable for the primary securities violations of their borrowers have survived motions to dismiss for failure to state a cause of action. The court in *In re Falstaff Brewing Corp. Antitrust Litigation*⁴⁵ recognized the sufficiency of the cause of action under section 10(b) where lenders had become involved in the day-to-day operations of their customer in order to monitor the customer's financial condition and prevent default on loans outstanding with the bank. Although the control exerted in that case was blatant, the case remains significant for its precedential value. For example, a lender may not agree to extend credit unless it can retain a degree of control over the funds advanced to the borrower. Similarly, a lender may include restrictive covenants and special provisions in the loan document regarding both the use of the funds extended and the protection of the collateral supporting the loan. Both examples demonstrate types of control a lender may impose upon its borrower.⁴⁶

III. Antifraud Provisions

Section 17(a) of the Securities Act of 1933

Section 17(a) of the 1933 Act imposes primary liability upon persons in the offer or sale of securities who, directly or indirectly, defraud or mislead buyers by making untrue statements or omitting material facts, or who engage in any transaction, practice, or course of business that operates or would operate as a fraud or deceit upon the purchaser.⁴⁷ Although the prohibitions of section 17 are strong, the statute does not specifically provide

45. 441 F. Supp. 62, 65 (E.D. Mo. 1977). Allegations included that defendants required Falstaff to: (1) replace acting officers and directors; (2) implement certain policies; (3) revise its debt structure; (4) obtain an equity investor; (5) give additional security; and (6) obtain approval before acquiring or selling capital assets.

46. Bartlett, *supra* note 38, at 652. The authors also delve into the implications of Connor v. Great Western Sav. & Loan Ass'n, 69 Cal. 2d 850, 447 P.2d 609, 73 Cal. Rptr. 369 (1968), which is outside the scope of this commentary. See also Greenberg, *The Liability of Banks for Aiding and Abetting Violations of the Securities Laws*, 4 ALI-ABA RESOURCE MATERIALS, BANKING AND COMMERCIAL LENDING LAW (1983) discussed *infra* at notes 149-151. For additional case law regarding the scope of controlling persons, see Hamilton Bank & Trust Co. v. Holliday, 469 F. Supp. 1229 (N.D. Ga. 1979); Ingenito v. Bermec Corp., 441 F. Supp. 525 (S.D.N.Y. 1977); Stern v. American Bankshares Corp., 429 F. Supp. 818 (E.D. Wis. 1977); Metzger v. American Food Mgt., Inc., 389 F. Supp. 469 (W.D. Pa. 1975); Smith v. Manausa, 385 F. Supp. 443 (E.D. Ky. 1974), *modified*, 535 F.2d 353 (6th Cir. 1976); Holloway v. Howerdd, 377 F. Supp. 754 (M.D. Tenn. 1973), *aff'd*, 536 F.2d 698 (6th Cir. 1976); Dyer v. Eastern Trust & Banking Co., 336 F. Supp. 890 (D. Me. 1971); Moerman v. Zipco, Inc., 302 F. Supp. 439 (E.D.N.Y. 1969), *aff'd*, 422 F.2d 871 (2d Cir. 1970). For cases involving allegations against a lender as a control person, see Woodward v. Metro Bank, 522 F.2d 84 (5th Cir. 1975); Richardson v. MacArthur, 451 F.2d 35 (10th Cir. 1971); Fuls v. Shastina Prop., Inc., 448 F. Supp. 983 (N.D. Cal. 1978); *In re Falstaff Brewing Corp. Antitrust Litig.*, 441 F. Supp. 62 (E.D. Mo. 1977); Ferland v. Orange Groves, Inc., 377 F. Supp. 690 (M.D. Fla. 1974). See generally Douglas-Hamilton, *Creditor Liabilities Resulting from Improper Interference with the Management of a Financially Troubled Debtor*, 31 BUS. LAW. 343 (1975).

47. 15 U.S.C. § 77q(a) (1982).

for a private right of action. Doubt has been voiced as to whether an implied civil right of action exists under section 17(a).⁴⁸ Four circuits, the Second,⁴⁹ the Fourth,⁵⁰ the Seventh,⁵¹ and the Ninth,⁵² have implied a private right of action under section 17(a). The Fifth⁵³ and the Eighth⁵⁴ circuits have rejected the notion. The United States District Court for the Western District of Oklahoma recently stated that the Tenth Circuit would probably allow a private civil cause of action under section 17(a).⁵⁵

The majority of all claims against lending institutions, however, have been brought under section 10(b) and rule 10b-5 because it is established that a private right of action exists thereunder.⁵⁶

Section 10(b) of the Securities Exchange Act of 1934 and SEC Rule 10b-5

Nearly word for word the same as their predecessor, section 17(a), section 10(b),⁵⁷ and rule 10b-5⁵⁸ have been termed the catch-all provisions of the

48. *Mendelsohn v. Capital Underwriters, Inc.*, 490 F. Supp. 1069, 1080 (N.D. Cal. 1979): It is one thing to imply a private right of action under § 10(b) or other provisions of the 1934 Act. . . . But it is quite another thing to add an implied remedy under § 17(a) of the 1933 Act to detailed remedies specifically created by §§ 11 and 12. The 1933 Act is a much narrower statute. It deals only with disclosure and fraud *in the sale of securities*. . . . 3 Loss, Securities Regulation, 1758 (2d ed. 1961)

(Emphasis added.) See also *Shell v. Dain, Kalman & Quail, Inc.*, 561 F.2d 152, 155 (8th Cir.), cert. denied, 434 U.S. 1086 (1977); *Scarfarotti v. Bache & Co.*, 438 F. Supp. 199, 207 (S.D.N.Y. 1977); *Gunter v. Hutcheson*, 433 F. Supp. 42 (N.D. Ga. 1977); *Ferland v. Orange Groves of Florida, Inc.*, 377 F. Supp., 690, 706 (M.D. Fla. 1974); *Dyer v. Eastern Trust & Banking Corp.*, 336 F. Supp. 890, 903 (D. Me. 1971).

49. *Kirshner v. United States*, 603 F.2d 234, 241 (2d Cir. 1978), cert. denied, 444 U.S. 995 (1980).

50. *Newman v. Prior*, 518 F.2d 97, 99 (4th Cir. 1975).

51. *Daniel v. International Bhd. of Teamsters*, 561 F.2d 1223, 1244-45 (7th Cir. 1977), *rev'd on other grounds*, 439 U.S. 551 (1979).

52. *Stephenson v. Calpine Conifers II, Ltd.*, 652 F.2d 808, 815 (9th Cir. 1981) ("In light of the minimal differences between § 17(a) of the 1933 Act and § 10(b) of the 1934 Act, we think the reasoning of the Second Circuit is persuasive and find that a private right of action exists under § 17(a)."); *SEC v. Texas Gulf Sulphur, Inc.*, 401 F.2d 833 (2d Cir. 1968), cert. denied, 404 U.S. 1005, *reh'g denied*, 404 U.S. 1064 (1972).

53. *Landry v. All-American Assur. Co.*, 688 F.2d 381, 391 (5th Cir. 1982).

54. *Shull v. Dain, Kealman & Quail, Inc.*, 561 F.2d 152, 155 (8th Cir. 1977). See also *In re New York City Mun. Sec. Litig.*, 507 F. Supp. 169, 187 (S.D.N.Y. 1980); *Eriksson v. Galvin*, 484 F. Supp. 1108, 1127 (S.D.N.Y. 1980); *Marbury Mgt., Inc. v. Kohn*, 470 F. Supp. 509, 514 n.9 (S.D.N.Y.), *modified on other grounds*, 629 F.2d 705 (2d Cir. 1979), cert. denied, 449 U.S. 1011 (1980). *Contra*, *Anschutz Corp. v. Kay Corp.*, 507 F. Supp. 72, 75 (S.D.N.Y. 1981).

55. *Geller v. Prudential-Bache Sec., Inc.*, [1983-1984 Transfer Binder] FED. SEC. L. REP. (CCH), ¶ 91,542 (W.D. Okla. 1983).

56. *Touche Ross & Co. v. Redington*, 442 U.S. 560, 569 (1979); *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976).

57. 15 U.S.C. § 78j(b) (1982) (section 10(b) of the Securities Exchange Act of 1934).

58. 17 C.F.R. § 240.10b-5 (1984).

1934 Act.⁵⁹ Section 10(b) is directed toward prevention of the employment of manipulative and deceptive practices in the purchase or sale of any security. Despite controlling authority that a private right of action is available under 10(b), its use as a basis for secondary liability interpreted through common law doctrines has been called into question by at least one legal scholar.⁶⁰

Daniel R. Fischel advocates that secondary liability by aiding and abetting, conspiracy, and respondeat superior common law doctrines are without section 10(b) and rule 10b-5 as drafted and intended by Congress. He theorizes that secondary liability under section 10(b) is no longer viable in light of recent Supreme Court decisions strictly interpreting the federal securities laws.⁶¹ Acceptance of Fischel's theory by the Supreme Court and lower federal courts would be favorably received by lending institutions presently facing the uncertainties of secondary section 10(b) liability. Nevertheless, all circuit courts of appeal that have faced the issue have found that a defendant can be held liable for aiding and abetting another defendant who violates section 10(b) and rule 10b-5.⁶² It is therefore unlikely that such cause of action will be eliminated in the near future.

IV. *Common Law Theories*

Aiding and Abetting

Several allegations tend to be predominant in complaints against lenders for secondary liability under section 10(b). Typically, most complaints are prefaced with the allegation that the defendant lender aided and abetted the stated violations. Three elements of common law aiding and abetting liability are generally required: (1) The existence of a securities law violation by the primary violator; (2) knowledge of the primary violation on the part of the aider and abettor; and (3) "substantial assistance" by the aider and abettor in the primary violation.⁶³

The degree of knowledge necessary and the acts constituting substantial

59. *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 202 (1976).

60. Fischel, *Secondary Liability Under Section 10(b) of the Securities Act of 1934*, 69 CALIF. L. REV. 80 (1981).

61. The proper inquiry, and, indeed, the only relevant inquiry, is whether Congress intended to prohibit the challenged conduct in question. When congressional intent, as determined by the language, structure and legislative history of a statute is used as the touchstone of liability, the proper range of defendants subject to liability under section 10(b) and rule 10b-5 contracts dramatically. Thus, various classes of defendants who have previously been held to be secondarily liable, such as lawyers or accountants who fail to "blow the whistle," employers who do no more than employ wrongdoers, and banks which knowingly finance a wrongdoer, should no longer be held liable since they have not engaged in any conduct prohibited by the statute.

Id. at 111 (emphasis added).

62. *Id.* at 81.

63. *Stokes v. Lokken*, 644 F.2d 779 (8th Cir. 1981); *IIT, An Int'l Inv. Trust v. Cornfeld*, 619 F.2d 909, 922 (2d Cir. 1980); *Woodward v. Metro Bank*, 522 F.2d 84 (5th Cir. 1975). See

assistance have become the focus of judicial interpretation. Two knowledge standards have developed: (1) "generally aware of his role in improper activity,"⁶⁴ and (2) "actual knowledge of the fraudulent scheme."⁶⁵

Examinations of the facts concerning the securities violation and the quantity and quality of contact between the primary and secondary defendants are frequently blended by courts to substantiate a common-sense determination that the secondary defendant must have known of the illegal conduct. Common sense "must have known" is then translated by the courts into a more comfortable "actually knew" holding. This tendency to elevate the knowledge requirement is justified only because courts are naturally hesitant to punish a defendant for an act or failure to act when he did not or should not have known that the proscribed activities were conducted by the primary defendant.

Knowledge under common law aiding and abetting analysis is substantially related to the intent requirement demanded in *Ernst & Ernst v. Hochfelder*.⁶⁶ Intent to deceive, manipulate, or defraud logically implies knowledge by the secondary defendant of the illegality of the conduct. "Manipulative or deceptive," used in conjunction with "device or contrivance," suggests that section 10(b) is intended to proscribe knowing or intentional misconduct. However, because the United States Supreme Court left open the question of whether, in some instances, reckless behavior is sufficient for civil liability under section 10(b) and rule 10b-5,⁶⁷ case law from diverse factual situations is still important to qualify the knowledge necessary to find secondary liability.

Ruder, in his pre-*Hochfelder* comments,⁶⁸ argued that impositions of a duty to investigate, i.e., acquire knowledge, under the guise of a "should

also Greenberg, *supra* note 46, at 51 n.3; *Brennan v. Midwestern United Life Ins. Co.*, 259 F. Supp. 673 (N.D. Ind. (1966)).

64. *SEC v. Coffey*, 493 F.2d 1304, 1316 (6th Cir. 1974), *cert. denied*, 420 U.S. 908 (1975); *Gould v. American-Hawaiian S.S. Co.*, 535 F.2d 761, 779 (3d Cir. 1976); *Woodward v. Metro Bank*, 522 F.2d 84, 97 (5th Cir. 1975); *SEC v. National Bankers Life Ins. Co.*, 324 F. Supp. 189, 195 (N.D. Tex. 1971), *aff'd per curiam*, 448 F.2d 652 (5th Cir. 1971).

65. *Saltzman v. Zern*, 407 F. Supp. 49 (E.D. Pa. 1976).

66. 425 U.S. 185 (1976).

67. *Id.* at 193 n.13.

68. Ruder, *supra* note 39, at 632-33:

[D]ifferent considerations enter into eliminating scienter as an element of aiding and abetting or conspiracy and substituting a duty of inquiry or a "should have known" standard. In most cases, the alleged aider and abettor (or conspirator) will merely be engaging in customary business activities, *such as loaning money*, managing a corporation, preparing financial statements, distributing press releases, completing brokerage transactions, or giving legal advice. If each of these parties will be required to investigate the ultimate activities of a party whom he is assisting, a burden may be imposed on business that is too great.

. . . .

The essential point is that imposition of a duty to investigate under the guise of a "should have known" standard in essence would amount to eliminating scienter as a necessary element in imposing aiding and abetting liability and the substitution of a negligence standard. [Emphasis added.]

have known" standard would amount to eliminating scienter as a requisite element of aiding and abetting liability. Actual knowledge of the fraud or recklessness in failing to discover the fraud, however, has been held sufficient to satisfy the second common law element of aiding and abetting in post-*Hochfelder* cases.⁶⁹ "Knowledge may be shown by circumstantial evidence, or by reckless conduct, but the proof must demonstrate actual awareness of the party's role in the fraudulent scheme."⁷⁰ Actual awareness of the illegal conduct of the primary party will indisputably suffice where the common law elements of aiding and abetting serve as the analytical basis for section 10(b) and rule 10b-5 liability.

The recent decision of *Dirks v. Securities & Exchange Commission*,⁷¹ concerning a tippee's duty to disclose material nonpublic information received from an insider who breached his fiduciary relation to the shareholders of a corporation, may reflect the United States Supreme Court's opinion regarding the degree of knowledge necessary to satisfy the language of section 10(b). In *Dirks*, the court held that a tippee assumes a fiduciary duty to the shareholders of a corporation not to trade on material nonpublic information only when an insider has breached his fiduciary duty to the shareholders by disclosing information to the tippee and the tippee knows or *should have known* that there has been a breach.⁷² The court reemphasized its decision in *Chiarella v. United States*,⁷³ which held that a section 10(b) duty to disclose is predicated upon the finding of a fiduciary relationship.⁷⁴ The court found that *Dirks* had no fiduciary duty because his tipper had no such duty. Thus the issue of whether *Dirk's knowledge* of the source of the information was sufficient for section 10(b) purposes was never discussed.

Whether a lender's relationship with a borrower must be comparable to

69. *Tucker v. Janota*, [1979 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,701 (N.D. Ill. 1978); *Stern v. American Bankshares Corp.*, 429 F. Supp. 818 (E.D. Wis. 1977). Judge Warren, after a review of the controlling concepts of *Hochfelder*, stated that the plaintiff must allege and prove:

- (1) That the person charged as an aider and abettor had *knowledge* of the fraud or *acted so recklessly that knowledge of the fraud may be imputed to him* and,
- (2) either (a) having actively participated in the transaction in an effort to assist the violator in the completion of the transaction, or (b) have failed to disclose the fraud to the plaintiff in breach of a *duty to disclose* owing to the plaintiff.

Tucker, supra, at 93,974 (emphasis added), citing from *Stern*, 429 F. Supp. at 826. See also *Zatkin v. Primuth*, [1982 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 98,832 (S.D. Cal. 1982) (an accounting firm may be held liable for secondary liability under rule 10b-5 if it knows, or is reckless in not knowing, that its client has committed a primary violation and it substantially aids the client in the overall enterprise); *SEC v. Seaboard Corp.*, 677 F.2d 1301 (9th Cir. 1982); *Nelson v. Serwold*, 576 F.2d 1332 (9th Cir.), *cert. denied*, 439 U.S. 970 (1978).

70. *Saltzman v. Zern*, 407 F. Supp. 49, 55 (E.D. Pa. 1976), citing A. BROMBERG, SECURITIES LAW FRAUD § 8.5, at 582 (1974).

71. 681 F.2d 824 (D.C. Cir. 1982), *rev'd*, 463 U.S. 646 (1983).

72. 463 U.S. at 654.

73. 445 U.S. 222 (1980). *Chiarella* is discussed *infra* at notes 158-164 and accompanying text.

74. *Dirks v. SEC*, 681 F.2d 824 (D.C. Cir. 1982), *rev'd*, 463 U.S. 646 (1983).

an insider's fiduciary duty to a corporation before the "knew or should have known" standard alluded to in *Dirks* would apply remains an open question. Related thereto, and discussed *infra* in part VII, is the issue of whether a lender must disclose to securities purchasers information gained about the borrower. Further, to satisfy a "should have known" standard for section 10(b), must a lender make a detailed inquiry into the activities of its borrower? Despite *Dirks*, a reasonable interpretation of *Hochfelder* demands that no responsibility for the actions of the primary violator attach absent actual knowledge on the part of the aider and abettor.⁷⁵

Substantial assistance by the alleged aider and abettor in accomplishing the illegal ends of the primary violator is the final element considered by courts that analyze section 10(b) and rule 10b-5 secondary liability on an aiding and abetting theory. "Substantial assistance" suggests action or inaction and, like knowledge, is not fairly subject to an exclusive definition. Accordingly, case law interpretation provides the only insight into this concept.

Part V of this commentary gives examples of conduct that either has or has not constituted substantial assistance. Because both knowledge and substantial assistance must be directly related to acts or omissions prohibited under section 10(b) and rule 10b-5, considerable attention is directed to those issues. In particular, analysis of section 10(b) and rule 10b-5 prohibitions will be directed to actual and potential instances of primary and secondary liability of lending institutions.

Respondeat Superior

Respondeat superior has been asserted as a basis for secondary liability under the federal securities laws. The circuit courts do not agree whether this theory should be available. The Second,⁷⁶ the Fifth,⁷⁷ the Sixth,⁷⁸ and the Seventh⁷⁹ circuits have taken the position that a violator of federal se-

75. See *Woodward v. Metro Bank*, 522 F.2d 84 (5th Cir. 1975).

If the alleged aider and abettor conducts what appears to be a transaction in the ordinary course of his business, more evidence of his complicity is essential. . . . If the securities involved are shares of common stock and someone aids and abets a fraud in their sale, the culprit would be hard pressed to argue innocence once his awareness of the general sales activity was shown. On the other hand, if the document is barely a security at all, like a loan, then other independent commercial assumptions come into play, and the alleged aider and abettor may be unaware of any improper activity. Still, even for facially ordinary commercial transactions, a court may be influenced by a *special duty imposed by the securities acts* on the particular type of a party, such as an insider, a controlling person, an accountant or a broker.

Id. at 95-96 (emphasis added).

76. *Marbury Mgt., Inc. v. Kohn*, 629 F.2d 705 (2d Cir. 1980).

77. *Paul F. Newton & Co. v. Texas Commerce Bank*, 630 F.2d 1111 (5th Cir. 1980), *reh. denied*, 634 F.2d 1355 (5th Cir. 1980).

78. *Holloway v. Howerdd*, 536 F.2d 690 (6th Cir. 1976); *Armstrong, Jones & Co. v. SEC*, 421 F.2d 359 (6th Cir.), *cert. denied*, 398 U.S. 958 (1970).

79. *Henricksen v. Henricksen*, 640 F.2d 880 (7th Cir.), *cert. denied*, 454 U.S. 1097 (1981); *Fey v. Walston & Co.*, 493 F.2d 1036 (7th Cir. 1974).

curities laws may be liable under controlling person provisions,⁸⁰ a respondeat superior theory, or both. The Third,⁸¹ the Eighth,⁸² and the Ninth⁸³ circuits have held that controlling person liability is the exclusive standard for determining vicarious liability for federal securities law violations. The Fourth and the Tenth circuits have not expressly ruled one way or the other.⁸⁴ The Western District of Oklahoma, however, has stated that respondeat superior is available as a means of imposing secondary liability for a securities law violation in a churning action.⁸⁵ The Supreme Court has not specifically addressed the question of whether respondeat superior is an available means to establish violations of federal securities laws.⁸⁶

V. Securities Acts Liability for Lending Institutions

Conduct actionable under the securities laws for which lending institutions have been held liable has assumed many forms.⁸⁷ However, restricting discussion to cases where lenders have been attacked as parties to securities violations by virtue of their lender-borrower relationships with the primary violators, the case law is incomplete as to exactly what conduct will render a lender responsible under the securities laws. Not surprising, the cases tend to depend heavily upon their facts. The degree to which the lender was involved with its borrower has been the determinative factor in the assessment of either controlling person or secondary aiding and abetting liability. The flavor of these cases is revealed by an examination of their facts.

A much cited case is *Monsen v. Consolidated Dressed Beef Co.*⁸⁸ The Third Circuit faced "the perplexing dilemma of ascertaining when the legitimate business relationship between a lender and its borrower leaves the realm of propriety and enters the domain of proscribed conduct."⁸⁹

80. 15 U.S.C. § 77(o)(1982); 15 U.S.C. § 78T(a) (1982).

81. *Rochez Bros., Inc. v. Rhoades*, 527 F.2d 880 (3d Cir. 1975); *Thomas v. Duralite Co., Inc.*, 524 F.2d 577 (3d Cir. 1975).

82. *Myzel v. Fields*, 386 F.2d 718 (8th Cir. 1967), *cert. denied*, 390 U.S. 951 (1968).

83. *Zweig v. Hearst*, 521 F.2d 1129 (9th Cir.), *cert. denied*, 423 U.S. 1025 (1975); *Douglass v. Glen Hinton Inv., Inc.*, 440 F.2d 912 (9th Cir. 1971); *Hecht v. Harris, Upham & Co.*, 283 F. Supp. 417 (N.D. Cal. 1968), *modified on other grounds*, 430 F.2d 1202 (9th Cir. 1970).

84. In *Johns Hopkins University v. Hutton*, 422 F.2d 1124, 1130 (4th Cir. 1970), the court found that a broker-dealer's liability for churning could arise from agency principals. In *Haynes v. Anderson & Strudwick, Inc.*, 508 F. Supp. 1303 (E.D. Va. 1981), the court analyzed the Fourth Circuit's prior decisions that in some manner related to the theory of respondeat superior and determined that respondeat superior should not be a theory for recovery for securities law violations. In *Richardson v. MacArthur*, 451 F.2d 35, 41 (10th Cir. 1971), the court imposed "controlling person" liability and stated that section 20(a) is not restricted by agency principals.

85. *Liskey v. Oppenheimer & Co.*, [1981-1982 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 98,419 (W.D. Okla. 1982). *See also* *Frankel v. Wyllie & Thornhill, Inc.*, 537 F. Supp. 730 (W.D. Va. 1982).

86. *But see* *Affiliated Ute Citizens v. United States*, 406 U.S. 128 (1972).

87. *See, e.g.*, *Carroll v. First Nat'l Bank*, 413 F.2d 353 (7th Cir. 1969), *cert. denied*, 396 U.S. 1003 (1970); *Frankel v. Wyllie & Thornhill, Inc.*, 537 F. Supp. 730 (W.D. Va. 1982); *Woods v. Homes & Structures, Inc.*, 489 F. Supp. 1270 (D. Kan. 1980); *Marrero v. Banco di Roma (Chicago)*, 487 F. Supp. 568 (E.D. La. 1980).

88. 579 F.2d 793 (3d Cir.), *cert. denied*, 439 U.S. 930 (1978).

89. 579 F.2d at 795.

Consolidated and its lender bank were sued in a class action instituted on behalf of the holders of unregistered securities. The securities were promissory notes issued by Consolidated in connection with its voluntary employee payroll deduction plan. Information, payment for the notes, and the notes were circulated in interstate commerce or through the mails. The notes were not registered as required by the federal securities laws. The note program was highly successful for a number of years and Consolidated never missed payments to its employees despite the fact that it had accumulated several thousand dollars of debt on the obligations issued under the program.

To compete in the industry, Consolidated turned to the defendant bank to obtain additional financing. The bank requested and received extensive information concerning the note programs and agreed to extend a loan to Consolidated. The terms of the loan agreement included subordination of Consolidated's obligations to its employees under the program and restrictions that Consolidated was not to borrow from other sources. The bank encouraged Consolidated to continue its note program and was aware that Consolidated never informed the note holders that their investments had been subordinated to the bank's security interest.

After the loan was finalized, the bank received monthly profit-and-loss statements and quarterly financial reports, and it knew Consolidated's financial condition was steadily deteriorating, yet it failed to have the note programs curbed. When Consolidated began failing financially, the bank seized control and prevented Consolidated from paying interest on the notes or honoring the notes at maturity.

The case was submitted to the jury on written interrogatories. The jury found Consolidated liable under section 12(2) of the 1933 Act and section 10(b) of the 1934 Act. Consolidated's misleading statements and omissions in connection with the note program also made the bank liable as an aider and abettor, but the bank was exonerated of any liability under section 10(b) of the 1934 Act.

The bank was granted a motion for judgment n.o.v. on the securities counts because the district court determined that the evidence was insufficient to prove an *intent* by the bank to assist a primary violation of the securities law.⁹⁰ The circuit court disagreed, reinstated the jury verdict against the bank, and cited as critical the fact that the bank *knew* Consolidated would not reveal the bank's secured position to the note holders, yet encouraged the continuance of the note program. The court held that the bank had substantially assisted in Consolidated's violations.⁹¹

The bank had extensive actual knowledge of Consolidated's note program and encouraged its continuance. The obligations of Consolidated to its employees, evidenced by the promissory notes, had been subordinated to the bank as secured creditor. This secret was guarded by both Consolidated and the bank. Because the note program generated security collateral for the

90. *Id.* at 802-03.

91. *Id.* at 803.

loan, the bank obtained substantial information concerning the program's administration. From an economic standpoint, even if the bank knew that the notes had not been properly registered, that fact would not jeopardize the bank's position. The knowledge the bank did possess, however, exposed the bank to liability.

The question raised by *Monsen* is, absent extensive knowledge of the securities transaction concerned and substantial involvement with the business of the borrower, would the bank have been held liable merely by virtue of the fact that the bank extended a loan secured by those notes? The court in *Monsen* implied that had the justices been the triers of fact, they might not have held the bank liable.⁹²

An interesting contrast to *Monsen* is *Woodward v. Metro Bank*.⁹³ Although *Monsen* was primarily argued on a common law aiding-and-abetting theory, whereas the plaintiff's cause of action in *Woodward* rested on section 10(b) and rule 10b-5, a contrasting of the two cases is particularly interesting because the court in *Woodward* chose to base its analysis of the 10(b) statutory claims in terms of a common law aiding-and-abetting theory.⁹⁴ In addition, the court in *Monsen* was particularly careful to distinguish the facts in *Monsen* from those in *Woodward*.⁹⁵

Woodward concerned a scheme whereby the plaintiff was induced to make a loan, evidenced by a cross-collateral note to the president of a failing corporation. The 90-day note was secured by plaintiff's stock and a certificate of deposit. In return, the plaintiff was to receive a monthly stipend for "counseling" services for the life of the note. In the same time period, defendant bank had both the corporate account and the president's personal account. The bank had repeatedly experienced difficulty with the corporate account, which was plagued with a large number of insufficient fund checks. The bank had requested that the corporate accounts be changed to another bank, but it had no indication that the president's account was unstable. Both accounts were managed by the same bank officer and the plaintiff's note was signed in that officer's conference room. The same day that the plaintiff extended her loan to the corporate president, the president transferred funds to the corporate account and a large sum of insufficient funds checks were thereby paid by the defendant bank. The plaintiff was paid her counseling fee for four months, but ultimately one of the corporate checks was returned for lack of funds. When the 90-day note became due for renewal, the bank asked the plaintiff to provide additional collateral, which she did with checks from the corporate president payable to the bank. Three

92. *Id.* "It may be that had we been the triers of fact in this case we might not have held the Bank liable on this record, but the evidence does provide adequate support for jury's verdict and under our limited role on appeal we cannot usurp their function."

93. 522 F.2d 84 (5th Cir. 1975).

94. The line of analysis in *Woodward* illustrates the overlap and confusion between the statutory and common law causes of action.

95. *Monsen v. Consolidated Dressed Beef Co.*, 579 F.2d 793, 803 n.18 (3d Cir.), *cert. denied*, 439 U.S. 930 (1978).

months later, the corporation filed a Chapter 11 bankruptcy petition and the bank turned to the plaintiff for collection on the note. Plaintiff sued the bank under section 10(b) for failure to disclose the borrower's hopeless financial condition.

Noting the undefined scope of rule 10b-5 and its potential for creative use in thwarting securities frauds, the court proceeded to define the limits of that rule.⁹⁶ After setting forth the elements required to be proved in rule 10b-5 actions⁹⁷ and giving depth to their meaning,⁹⁸ the court then discussed aiding-and-abetting liability to determine whether Metro Bank's acts and omissions were sufficient for liability under rule 10b-5.

As the court in *Monsen* noted, the determinative factor in rule 10b-5 cases is the degree of knowledge of the alleged securities fraud the defendant possessed. Translating "knowing" into "scienter," the court in *Woodward* stated that the relationship between the bank's activity (i.e., participation in the fraud) varied inversely with the degree of scienter required to attach secondary liability to the defendant. "A remote party must not only be aware of his role, but he should also know when and to what degree he is furthering the fraud."⁹⁹ Using the term, "daily grist of the mill,"¹⁰⁰ the court concluded that the bank was not liable under the securities laws and affirmed the trial court's order dismissing the action as to the bank and the account officer.¹⁰¹

96. The court cited the language in *Herpich v. Wallace*, 430 F.2d 792, 804-05 (5th Cir. 1970):

In the formulation of relief, however, concepts of fairness to those who are expected to govern their conduct under Rule 10b-5 should be considered. Protection for investors is of primary importance, but it must be kept in mind that the nation's welfare depends upon the maintenance of a viable, vigorous business community. *Consolidated alone, the sweeping language of Rule 10b-5 creates an almost completely undefined liability.* All that the rule requires for its violation is that someone "do something bad," Jennings & Marsh, *Securities Regulation* 961 (2d ed. 1968), in connection with a purchase or sale of securities. *Without further delineation, civil liability is formless, and the area of proscribed activity could become so great that the beneficial aspects of the rule would not warrant the proscription.* See Ruder, *Pitfalls in the Development of a Federal Law of Corporations by Implication Through Rule 10b-5*, 59 Nw. U.L. Rev. 195, 207-208 (1964). *In recognition of this problem, courts have sought to construct workable limits to liability under section 10(b) and Rule 10b-5 which will accommodate the interests of investors, the business community, and the public generally.* [Emphasis added.]

97. The court cited *Sargent v. Genesco*, 492 F.2d 750 (5th Cir. 1974), for the elements that must be proved to establish a 10b-5 claim: (1) conduct by the defendants proscribed by the rule; (2) a purchase or sale of securities by the plaintiffs "in connection with" such proscribed conduct; and (3) resultant damages to the plaintiff.

98. *Woodward*, 522 F.2d at 93.

99. *Id.* at 95.

100. *Id.* at 97. "If the evidence shows no more than transactions constituting the daily grist of the mill, we would be loathe to find 10b-5 liability without clear proof of intent to violate the securities laws." Note that this statement may be construed to mean that the lender must know that his borrower's conduct violates the securities laws.

101. *Id.* at 100. The court in *Woodward* prefaced its judgment by stating:

While we are confident that our solution here is correct, we have written at length

The *Woodward* opinion was welcomed by lender counsel and is frequently cited. However, two issues that the court in *Woodward* confidently dismissed have become major lines of attack for plaintiffs: (1) whether the bank had a *duty* to disclose the corporation's past financial problems and the existence of other loans by the bank to the corporation and its president, and (2) whether the bank's silence regarding the cross-collateral clauses¹⁰² was "substantial assistance."¹⁰³

The critical difference between *Monsen* and *Woodward* was the defendant bank's (in *Woodward*) lack of knowledge of its borrower's fraud.¹⁰⁴ However, that distinction is none too comfortable without a uniform definition of what constitutes knowledge.¹⁰⁵ The recent case of *Wright v. Schock*¹⁰⁶ dealt with the issue of culpable knowledge and lender liability. The court's resolution of this and other issues is persuasive authority in determining the complex questions that arise in lender liability cases.¹⁰⁷

VI. *Wright v. Schock*

The plaintiffs in *Wright* brought a class action alleging violations of federal and state securities laws and common law fraud in connection with their purchase of promissory notes. The promissory notes, issued by Golden State Home Loans (GSHL), were secured by deeds of trust on real property and were characterized as lucrative but safe investments. Defendants in the action included two banks and nine title companies.

GSHL was a licensed mortgage loan broker soliciting trust deed investments through advertisements in newspapers, by telephone, by way of investment seminars, and by mail. GSHL serviced the loans and offered other enticements to investors.¹⁰⁸ The title companies were involved in preparing

to insure that our opinion will not be used to cordon off all bank-associated notes from the coverage of 10b-5. Under different facts, demonstrating awareness of complicity and substantial assistance, we would not hesitate to hold a bank to account.

102. The cross-collateral clause had the effect of extending the plaintiff's liability to the corporate president's two other outstanding personal loans.

103. Regarding the bank's duty to disclose, the court in *Woodward* stated: "The other loans . . . were confidential information that Metro had no duty to disclose to [the plaintiff] absent some new expansion of 10b-5." In the previous paragraph the court commented that "the *raison d'etre* of accommodation is to find stronger financial support for a proposed bill or note. We are not prepared effectively to abolish this commercial practice of Rule 10b-5 without some indication that Congress intended this result." *Woodward*, 522 F.2d at 99.

104. *Monsen v. Consolidated Dressed Beef Co.*, 579 F.2d 793 (3d Cir.), *cert. denied*, 439 U.S. 930 (1978).

105. See *supra* notes 63-75 and accompanying text.

106. 571 F. Supp. 642 (N.D. Cal. 1983), *aff'd*, 742 F.2d 541 (9th Cir. 1984).

107. *But cf.* *Little v. Valley Nat'l Bank*, 650 F.2d 218 (9th Cir. 1981). The district court in *Little* instructed the jury that wanton and reckless disregard for facts would suffice to show actual knowledge. Because the defendants did not attack the jury instructions on appeal, the circuit court did not rule on the legal question.

108. Under a servicing agreement, terminable on 30 days' notice by the investor, GSHL collected the borrowers' payments and remitted them to the investors. Promotional literature

preliminary title reports, issuing lenders' title insurance policies, and occasionally performing partial escrow services. The banks rendered services such as referring GSHL to prospective investors, maintaining checking accounts for GSHL, arranging for lock boxes, making loans to GSHL and its president personally, and extending a working line of credit to GSHL. One bank's name was printed on a loan-servicing agreement form used by GSHL as part of its promotional materials (although the bank asserted that use of its name in this manner was without authorization).¹⁰⁹ GSHL collapsed shortly after plaintiffs purchased the notes. The court stated that "[b]oth banks carried on no more than an ordinary banking relationship with GSHL. . . ."¹¹⁰

Plaintiffs asserted claims based on section 12(2) seller status, primary liability under sections 17(a), 10(b), and rule 10b-5, aiding and abetting, and controlling person liability.¹¹¹ Summary judgment was granted to the banks and title company defendants.

Addressing the issue of whether the banks and title companies could be brought within the statutory phrase "any person who—offers or sells a security,"¹¹² the court wrestled with how expansively section 12(2) should be read. Discussing the strict privity¹¹³ requirement and its continuing viability¹¹⁴ and the substantial factor tests,¹¹⁵ the court held that the defendant banks and title insurance companies were not sellers within the meaning of the statute. The court did not, however, expressly select either the strict privity or the substantial factor test. The court stated that although the title reports, availability of title insurance, and escrow services of the title companies, and the account services, *loans*, and general references of the banks may have been but-for causes of GSHL's sales of securities, they were not proximate causes or substantial factors in the sales.¹¹⁶ The opinion emphasized that other banks could have provided the loans and services and that title insurance was not a major inducement to the plaintiffs' investments.¹¹⁷

spoke of a policy of advancing payments to investors if the borrowers paid late, but did not mention reimbursement. All title work and escrow was to be arranged by GSHL.

109. *Id.*

110. *Wright v. Schock*, 571 F. Supp. 642, 655 (N.D. Cal. 1983), *aff'd*, 742 F.2d 541 (9th Cir. 1984).

111. *Id.* The court also extensively discussed whether promissory notes secured by deeds of trust on real property were within the statutory definition of a security. The deeds of trust were held to be securities.

112. 15 U.S.C. § 77i (1982).

113. *Wright v. Schock*, 571 F. Supp. 642, 657 (N.D. Cal. 1983), *aff'd*, 742 F.2d 541 (9th Cir. 1984). The district court noted: "This view has been espoused by the Third and Seventh Circuits. *Collins v. Signetics Corp.*, 605 F.2d 110, 113 (3d Cir. 1979). *Accord, Sanders v. John Nuveen & Co., Inc.*, 619 F.2d 1222, 1276 (7th Cir. 1980), *cert. denied*, 450 U.S. 1005 (1981)."

114. *Wright v. Schock*, 571 F. Supp. 642 (N.D. Cal. 1983), *aff'd*, 742 F.2d 541 (9th Cir. 1984), *citing Admiralty Fund v. Jones*, 677 F.2d 1289, 1294 n.3 (9th Cir. 1982).

115. *Wright*, 571 F. Supp. at 657, *aff'd* 742 F.2d 541 (9th Cir. 1984), *citing Hill York Corp. v. International Franchises, Inc.*, 448 F.2d 680, 692 (5th Cir. 1971).

116. *Wright v. Schock*, 571 F. Supp. at 657, *aff'd*, 742 F.2d 541 (9th Cir. 1984).

117. *Id.* "These defendants performed routine services in the ordinary course of business.

The justices did not linger over the plaintiffs' allegation that the defendants were secondarily liable for GSHL's alleged section 12(2) violation. The court expressed doubt as to whether aiding-and-abetting liability exists with respect to section 12(2) violations. In resolving this matter, the court found that secondary liability could extend no farther than the substantial factor test.

Plaintiffs argued that failure to disclose material information concerning GSHL's business and the risks of its trust and investments were grounds for primary violations under the antifraud provisions of section 17(a), section 10(b), and rule 10b-5. The analytical framework provided by *White v. Abrams*¹¹⁸ formed the basis for the court's decision. The court reasoned that even if the defendants possessed material information not available to the plaintiffs, the defendants were under no duty to disclose it.

Under *White*, whether a defendant is obligated to disclose material information to the plaintiff depends on the aggregate of several factors. One factor identified in *White* is the defendant's access to information as compared to the plaintiff's access.¹¹⁹ A second factor is whether the defendant was aware that the plaintiff was depending upon their relationship in making his investment decision.¹²⁰ The presence of several *White* factors, however, does not automatically create section 10(b) liability for failure to disclose material information.

Particular attention should be given to the court's application of the *White* factors to the facts of *Wright*. The court was sufficiently convinced that the banks' and title companies' relationship with the investors, although fairly substantial, was not sufficient to hold either class of defendants *primarily* liable for the asserted section 10(b) and rule 10b-5 violations and that summary judgment was merited.¹²¹

Regarding the issue of whether a private right of action under section 17(a) should be allowed, the court reasoned that the differences between section 10(b) and section 17(a) are minimal, disregarding the Supreme Court's

For any particular sale of an investment, neither the particular title company nor the particular bank involved was in any sense a necessary participant, since any other title company or bank could have provided identical services."

118. 495 F.2d 724 (9th Cir. 1974).

119. *Id.* at 735-36:

The relationship of the defendant to the plaintiff, the defendant's access to the information *as compared* to the plaintiff's access, the benefit that the defendant derives from the relationship, the defendant's awareness of whether the plaintiff was relying upon their relationship in making his investment decisions and the defendant's activity in initiating the securities transaction in question. (Footnotes omitted.)

The *White* factors continue to be used in the Ninth Circuit to define the scope of duty of disclosure a defendant owes a plaintiff in a 10(b) case despite the fact that *White* contemplated the possibility of liability under rule 10b-5 for negligence which was abrogated in *Hochfelder*. See *Wright*, [1983-1984 Transfer Binder] FED. SEC. L. REP. (CCH) at 96,363 n.9.

120. *White v. Abrams*, 495 F.2d 724 (9th Cir. 1974).

121. *Wright v. Schock*, 571 F. Supp. 642, 662 (N.D. Cal. 1983), *aff'd*, 742 F.2d 541 (9th Cir. 1984).

dictum that section 17(a) applies only to “sellers.”¹²² Both sections require the same showing of duty to disclose, scienter, and reliance. Therefore, having absolved both classes of defendants of primary section 10(b) liability, the court reasoned the same result must obtain under the section 17(a) complaint.¹²³

The *Wright* court formed its decision around the common law elements of aiding and abetting¹²⁴ and granted summary judgments to the defendants on the section 10(b) issue. Distinguishing a primary violator’s duty to disclose from the duty to disclose that pertains to aider-and-abettor liability, the court cited *Harmesen v. Smith*.¹²⁵ A primary violator’s duty to disclose arises from his involvement with the entity whose securities are at issue and his relationship to the plaintiffs. A secondary violator’s duty, however, arises from knowing assistance of or participation in a fraudulent scheme.¹²⁶

Neither the “knowledge” nor the “substantial assistance” burdens were carried by the plaintiffs to prevent summary judgment for the defendants. Specifically, pleading merely that the defendants “must have known” did not suffice to show actual knowledge, nor did the performance of what the court described as ministerial tasks amount to substantial assistance. Finally, the court refused to convert the defendants’ silence and inaction into substantial assistance absent evidence that the defendants sought to benefit themselves from the consummation of GSHL’s fraud.¹²⁷

The court also found the defendants not liable as controlling persons under section 15 of the 1933 Act and section 20 of the 1934 Act. “Plaintiffs’ theory—to call it ‘novel’ would be unduly complimentary—is that the banks and title companies collectively controlled GSHL because their services were indispensable.”¹²⁸

The disposition of *Wright* on defendants’ motion for summary judgment is significant. Viewing the facts pled in a light most favorable to the plaintiffs, the *Wright* court determined that there were no triable issues as to the defendants’ alleged liability. Specifically, these facts were, first, a history of financial dealings between GSHL and the defendant banks. Several loans and a line of credit secured by notes and deeds of trust exceeding a half million dollars had been extended to GSHL or its president. Second, one defendant bank’s name appeared on a loan-servicing agreement and both banks were listed as references in the promotional materials. Third, the GSHL accounts were among the five largest loans of one defendant bank. Finally,

122. 571 F. Supp. at 662.

123. *Id.*

124. The elements used in *Wright* are (1) the existence of an independent primary wrong; (2) *actual knowledge* by the alleged aider and abettor of the wrong and his role in furthering it; and (3) substantial assistance in the wrong. *Id.* at 662-63.

125. 693 F.2d 932, 943 (9th Cir. 1982), *cert. denied*, 104 S.Ct. 89 (1983).

126. *Id.*, citing *Monsen v. Consolidated Dressed Beef Co.*, 579 F.2d 793, 799 (3d Cir.), *cert. denied*, 439 U.S. 930 (1978); *Woodward v. Metro Bank*, 522 F.2d 84, 97 (5th Cir. 1975).

127. *Wright v. Schock*, 571 F. Supp. 642, 663 (N.D. Cal. 1983), *aff’d*, 742 F.2d 541 (9th Cir. 1984).

128. *Id.* at 664.

the nature of GSHL's enterprise had been communicated to officers of the defendant banks prior to the extension of loans to GSHL by those defendant banks. Presented with this evidence, the *Wright* court found that "the relationship between GSHL and the banks was not extraordinary"¹²⁹ and that "the banks possessed no greater knowledge than that presumably available to investors."¹³⁰

The *Wright* court, by choosing to dismiss the action without jury consideration, recognized the importance of preserving the traditional lender-borrower business relationship without subjecting lenders to exposure for the federal securities violations of their borrowers. By extrapolation and embellishment, the facts of *Wright* conform in operational impact with facts in cases currently pending before federal district courts.¹³¹ *Wright* should prove to be influential.

The *Wright* opinion is pro-lender but should not be considered dispositive on the issue of lending institution liability for the securities violations of their customers. The *Wright* case joins the company of several other pro-lender adjudications that seem to constitute a trend for current interpretation of the federal securities laws as those laws affect the traditional lender-borrower relationship.¹³²

Compare, however, the following case presented on motion for summary judgment by defendant lenders: A standing arrangement existed whereby prospective investors were regularly referred to one of the defendant lenders to procure loans for the purpose of purchasing the investments. The lender was willing to extend unsecured loans and this fact was made a selling point by the firm in attracting investors. The alleged securities violations were failure to comply with sections 12(2) and 10(b) and rule 10b-5. The lending institutions were accused of aiding and abetting these violations.

On facts substantially the same as these, the court in *Tucker v. Janota*¹³³ denied motions for summary judgment brought by the defendant banks.

129. *Id.* at 655.

130. *Id.* at 661: "[p]laintiffs present[ed] no evidence that the banks possessed anything more than very general knowledge about GSHL's operation, including the information obtainable from its financial statements—information presumably available to investors." See also Representative Plaintiffs' "Memorandum of Points and Authorities in Opposition to Motions for Summary Judgment," *Wright v. Schock*, 571 F. Supp. 642 (N.D. Cal. 1983, *aff'd*, 742 F.2d 541 (9th Cir. 1984).

131. See, e.g., *Wurzberg v. Cornelius*, First Consolidated and Amended Class Action Complaint, 83 Cir. 0628 (PNL), 83 Civ. 0794 (PNL), 83-0589 (JRx) (S.D.N.Y. July 19, 1983).

132. *Woodward v. Metro Bank*, 522 F.2d 84 (5th Cir. 1975); *Clark v. Cameron-Brown Co.*, [1980 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 97,539 (M.D.N.C. 1980); *Resource Inv. v. Natural Res. Inv. Corp.*, 457 F. Supp. 194 (E.D. Mich. 1978); *Fuls v. Shastina Prop., Inc.*, 448 F. Supp. 983 (N.D. Cal. 1978); *Ferland v. Orange Groves of Florida, Inc.*, 377 F. Supp. 690 (M.D. Fla. 1974).

133. [1979 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,701, at 94,716 (N.D. Ill. 1978). Defendants were granted a summary judgment on the issue of whether defendants had violated the margin requirement of section 7(c) of the 1934 Act. The court held there is no private right of action for a violation of section 7(c) of the Exchange Act. The requirements for aiding and abetting outlined by the court were that the alleged aider and abettor substantially aided

Adopting the position that the scienter element required for section 10(b) violations as announced by the Supreme Court in *Hochfelder*¹³⁴ may be satisfied by recklessness, the court believed summary judgment to be inappropriate because triable issues of fact existed as to the scienter possessed by the defendant banks.

VII. *Analysis*

Throughout the introductory part of this commentary and especially in part VI, two questions recur; the answers determine whether a lender will be held liable for the securities law violations of its borrower. The first question addresses the intended scope of the securities laws: Does or should a lender owe a duty to an investor to protect that investor from the securities law violations of its borrower? The second question proceeds from the assumption that such a duty does and should exist and asks the question central to the resolution of all lender liability cases: Did the lender fulfill its duty to the investor?

As the discussion in part VI illustrates, no court has expressly held that the securities acts do not impose a duty upon a lender to protect investors from the securities violations of its borrower. Rather, lender liability cases have turned upon the second question. However, as courts have attempted to define the nature of the duty a lender supposedly owes an investor by ruling whether certain conduct or omissions on the part of a lender violates the securities acts, the same courts have placed lenders in an economic predicament that contradicts the express policy underlying the federal securities acts. The impact of that statement is demonstrated by revealing the predicament that lenders currently face as potential exposure to liability for the securities violations of their borrowers increases, juxtaposed against the policy that the securities acts were intended to "protect the public with the least possible interference to honest business."¹³⁵

A common financial transaction between a lender and a borrower involves the extension of a loan to a limited partnership secured by the partnership's assets and personal notes from the limited partners. For example, suppose that an oil and gas company raises capital for its speculative ventures by selling limited partnership interests (securities). The buyers' investment decision is influenced, if not induced, by the company's representations of tax breaks, the company's financial strength based on the appraised present value of oil and gas reserves held by the company, and the company's history of success in finding and producing natural resources. The company then solicits an energy loan from a lending institution.

The lender makes independent evaluations of the financial condition of the company and determines that the company's reserves are not as extensive

the unlawful scheme and possessed some degree of scienter, *citing* *Woodward v. Metro Bank*, 522 F.2d 84, 94-97 (5th Cir. 1975).

134. 425 U.S. 185 (1976).

135. S. REP. No. 47, 73d Cong., 1st Sess. (1933).

or valuable as the borrower represents. After factoring in risks and profit, the lender decides to loan the company one half of the amount requested. The loan document contains language granting security interests in all present and future reserves and collateral owned by the company, covenants restricting the ability of the company to encumber the assets supporting the loan, and provisions requiring the company to make periodic financial reports to the lender. Presumably, these provisions render the lender a controlling person for purposes of the securities acts.

After a period of time, the company has exhausted the loan fund and requires additional operating capital to continue its ventures and to make interest payments on the loan. With the knowledge of the lender, the company sells more interests in the same limited partnership based on the same prospectus circulated before. In the second offering, however, the company makes fraudulent statements and omits material information to buyers.¹³⁶ The lender has no knowledge of this fraud.

Market conditions cause a precipitous decline in the price of oil and gas, which greatly devalues the company's stated reserves. The company is unable to fulfill its obligations under the loan, and the lender calls the notes and seizes the collateral, which forces the company to seek bankruptcy.

The disappointed investors discover the company's frauds and seek reimbursement; however, the bankrupt company has no ready assets from which a judgment against it can be satisfied. The first group of investors discover the discrepancy between the company's estimated reserves as reflected in the prospectus and the bank's valuation. The second group of investors contend that the relationship between the lender and the company was so close that the lender knew or should have known of the company's frauds. Both investor groups join and sue the solvent lender.

Several theories of liability are offered by the plaintiffs. The plaintiffs allege that the lender was a substantial factor inducing the sale of the security and is therefore primarily liable as a seller under section 12(2).¹³⁷ Additionally, it is asserted that because the lender omitted to disclose material facts it allegedly knew about the company, the lender is primarily liable under sections 17(a) and 10(b) and rule 10b-5.¹³⁸ Based on the provisions in the loan document, plaintiffs allege that the lender controlled the company and is therefore jointly and severally liable for the fraud of the company.¹³⁹ Finally, intermixing assertions of aiding and abetting¹⁴⁰ and section 10(b), the investors seek to hold the lender secondarily liable because the lender

136. The untrue statements made by the borrower to the investor constitute a basis for primary liability for the borrower under section 10(b) and rule 10b-5.

137. 15 U.S.C. § 77i (1982) (section 12(2) of the 1933 Act).

138. 15 U.S.C. § 77q(a) (1982) (section 17(a) of the 1933 Act), 15 U.S.C. § 78j(b) (1982) (section 10(b) of the 1934 Act), and 17 C.F.R. § 240.10-5 (1980), respectively.

139. 15 U.S.C. § 77(o) (1982) (section 15 of the 1933 Act) and 15 U.S.C. § 78(t) (1982) (section 20 of the 1934 Act).

140. Because the common law theories of aiding and abetting and respondeat superior are most frequently used by courts only as a framework for construing statutory provisions, further discussion of these theories is omitted.

pursued a course of business it knew or should have known, from its relationship with the company, indirectly allowed the company to defraud the investors. Is the lender liable under this set of facts?

Clearly, in the common use of the word, the lender was not a seller of the securities. However, if a court were to reject the strict privity approach¹⁴¹ and determine that the lender was a proximate cause or a substantial factor¹⁴² inducing the sale, the lender would be forced to establish the defenses provided in section 12(2) to escape liability as a seller. The lender would have to prove that it did not know and in the exercise of reasonable care could not have known of the untruths and omissions of the company to the investors.¹⁴³

As the facts stipulate, the lender presumably knew that the company had represented reserve values to investors that were higher than the lender's independent estimation of the values. Similarly, the lender knew that the company had sold a second set of interests in the same limited partnership to enable the company to make interest payments on the loan. The lender did not know, however, that the company had defrauded the second set of investors.

Assume for the moment that the lender can prove that it was appropriately ignorant of the company's misrepresentations and fraud sufficient to establish the section 12(2) defense. The lender must still refute controlling person primary liability and section 10(b) primary and secondary liability. As will be seen, the imposition of a knew or should have known standard¹⁴⁴ in section 10(b) cases, with the concomitant obligations to inquire and disclose, would require a lender to acquire more knowledge about its borrower in order to avoid section 10(b) liability. That additional knowledge would lessen the likelihood that the section 12(2) ignorance defenses could be supported.

Recall that under both securities acts a person who controls another person liable under the securities acts faces joint and several liability for the infraction unless, under the 1933 Act, the controlling person had no knowledge of or reasonable grounds to believe of the existence of the violation,¹⁴⁵ or, under the 1934 Act, acted in good faith and did not directly or indirectly induce the violation.¹⁴⁶ Assuming that the plaintiffs can convince the court that the lender controlled the company through the loan document, the lender is again faced with establishing a defense that depends greatly on what the lender knew or should have known about the securities violation. The availability of the defenses under sections 15 and 20 would be greatly affected by the amount of knowledge, and the disclosure thereof, the lender had to acquire to avoid secondary section 10(b) liability.

141. Silverstein, *supra* note 3.

142. *Id.*

143. 15 U.S.C. § 77I (1982).

144. *Dirks v. SEC*, 681 F.2d 824 (D.C. Cir. 1982), *rev'd* 463 U.S. 646 (1983).

145. 15 U.S.C. § 77(o) (1982).

146. 15 U.S.C. § 78T(a) (1982). See also *supra* note 42.

The lender must also avoid the catch-all scope of both primary and secondary liability under section 10(b) and rule 10b-5. Faced with the decision of whether the lender engaged in a course of business that operated as a fraud upon either group of investors because the lender knew that the company overstated the value of its reserves and/or because the lender knew that a second set of securities were sold, the court must determine whether the lender's knowledge constituted sufficient scienter¹⁴⁷ to violate section 10(b) and rule 10b-5. If a court were to adopt the knew-or-should-have-known standard,¹⁴⁸ that court would effectively require that lenders diligently scrutinize the securities sales of their borrowers in order to enable the lender to discharge its supposed duty of disclosure to the investor to avoid secondary section 10(b) liability.

The predicament the lender faces in order to exculpate itself from the various theories of liability is that to avoid secondary section 10(b) liability, it must adequately inquire into the securities sales of its borrowers and disclose to the investors any suspected violations of the securities acts. On the other hand, the knowledge the lender thereby gains reduces the likelihood that it could establish the ignorance and good faith defenses to seller and controlling person primary liability.

Stephen J. Greenberg concluded that to avoid aider-and-abettor liability, a lending institution that has financing arrangements with public companies or persons engaged in securities transactions would have to scrutinize all transactions the lender finances.¹⁴⁹ Greenberg also foresaw the paradox that "the more the bank learns, the greater the likelihood that it can be held liable for the conduct of its borrower."¹⁵⁰ Greenberg's solution is for the lender quickly to voice any objection it has to the unlawful conduct of its borrower.¹⁵¹ Greenberg apparently realizes that rather than gambling that it can overcome a knew-or-should-have-known standard in section 10(b) cases, a lender will elect to inquire into the conduct of its borrower and then disclose to investors any suspected securities violations.

Greenberg's solution is, however, incomplete and unrealistic for three reasons. First, provided that due inquiry and disclosure are the means by which a lender can avoid section 10(b) liability, the lender then must decide what it must and can disclose to investors without violating its obligation of confidentiality to its borrower. Second, applying a broad knew-or-should-have-known standard to section 10(b) would necessarily affect the lender's ability to establish the more conservative defenses to seller and controlling person liability. Third, the economic costs of conducting what would, in effect, be a due diligence inquiry, added to the increased risk that the lender might violate its duty of confidentiality to its borrower when the lender fulfills its

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

148. *See supra* notes 63-75 and accompanying text.

149. Greenberg, *supra* note 46, at 49.

150. *Id.*

151. *Id.*

duty of disclosure, would either be included in the costs of loans to such borrower, or lenders would choose to abstain from making the loans.

If the knew-or-should-have-known standard were applied in section 10(b) cases, then a lender would be faced with two choices. First, it could accept an increased probability that a plaintiff could prove that because of the relationship between the lender and the borrower, the lender should have known about the securities violations of its borrower. Alternatively, the lender could police the activities of its borrowers and disclose all suspected or potential infractions. The latter alternative seemingly complements the investor protection policy of the securities acts;¹⁵² however, it also presupposes that the lender *should* have a duty of disclosure. Discussion regarding the desirability of requiring that a lender inquire and disclose immediately follows, but the decision whether the knowledge, once gained, must be disclosed differs materially from the requirement that the lender must acquire that information. The difference also affects the availability of the defenses to seller and controlling person liability.

Although a lender may decide that it would not be required to disclose certain types of information, it must also contend with the predicament that (1) if the lender fails to inquire, it may be held that it should have known; (2) to reach the disclosure decision it must gain knowledge; and (3) the lender's increased knowledge reduces the likelihood that the seller and controlling person defenses can be supported.

The same knowledge standard should be used for purposes of the defenses to seller and controlling person liability as is used for secondary section 10(b) liability. Permitting a lender to escape section 10(b) liability by defining what can and must be disclosed to investors without rejecting the knew-or-should-have-known standard would not reduce the lender's predicament concerning seller and controlling person liability.

As might be expected, the cases discussing the general issues of duty to disclose under section 10(b) and rule 10b-5 are by no means consistent. At one extreme is *Rosen v. Dick*,¹⁵³ where a corporation's trustee in reorganization brought an antifraud suit against the board of directors and Dick, a former officer of the corporation. The suit alleged that Dick and the board had colluded to induce the corporation to release all claims against the defendant bank. The trustee pled that the release was inoperative.

Dick had fraudulently sold securities to the corporation. It was alleged that the board of directors knew of Dick's fraud and that the release granted to the bank was part of a broader illegal agreement between the board, Dick, and the bank to conceal Dick's defalcations and the directors' knowledge thereof from the corporation's shareholders and the appropriate regulatory authorities.¹⁵⁴ The bank moved the court to dismiss on the basis that the bank had no duty to disclose Dick's frauds and that it did not affirm-

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

153. [1974-75 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 94,786 (S.D.N.Y. 1974).

154. *Id.* at 96,604.

actively make any misrepresentations to the corporation concerning the sale.¹⁵⁵

The *Rosen* court denied the bank's motion to dismiss and stated that, in order to be held as an aider and abettor of a securities fraud, it was "not necessary that the bank had any affirmative duty to disclose Dick's defalcations"¹⁵⁶ to the corporation. "[S]econdary liability under the federal securities laws may be imposed if a person has actual knowledge of another's improper scheme plus an intent to further that scheme (i.e., scienter) and he has given substantial assistance to the primary wrongdoer."¹⁵⁷

Whether the *Rosen* court would have made the same statement if a knew-or-should-have-known standard had been applied, rather than the actual knowledge standard used, or, instead, would have determined that the bank had an affirmative duty to disclose its knowledge to the corporation, is an open question. The liberality of *Rosen* is, however, questionable because of the subsequent decision in *Chiarella v. United States*.¹⁵⁸

In *Chiarella* the Supreme Court addressed whether secondary liability under section 10(b) was appropriate where a financial printer, who had discovered the identity of merger target companies, had made profitable stock trades based on that information. The court mentioned decisions holding dealers,¹⁵⁹ corporate insiders,¹⁶⁰ and tippees¹⁶¹ liable for nondisclosure, but flatly rejected the contention that the printer was under a duty to everyone, to the market as a whole, to disclose the information.¹⁶² The Court stated:

Formulation of such a broad duty, which departs radically from the established doctrine that duty arises from a specific relationship between two parties . . . should not be undertaken absent some explicit evidence of congressional intent.¹⁶³

. . . .

We hold that a duty to disclose under section 10(b) does not arise from the mere possession of nonpublic information.¹⁶⁴

In *Chiarella* there was no question as to what the printer knew. Rather, the court refused to create a duty between the printer and the investors that was not explicitly intended by Congress. Similarly, there is no explicit evidence to indicate that Congress intended a lender to owe a duty of disclosure to investors. *Chiarella* was using the information for his own purposes and financial benefit, just as a lender uses information about its borrower for the lender's own purposes and financial benefit (i.e., repayment of the loan). Thus, unless the relationship between a lender and an investor is materially

155. *Id.*

156. *Id.*

157. *Id.*

158. 445 U.S. 222 (1980).

159. *Id.* at 226.

160. *Id.* at 229.

161. *Id.* at 230 n.12.

162. *Id.* at 232.

163. *Id.* at 233.

164. *Id.* at 235.

different than the relationship between a financial printer and the trading public, the lender should have no duty to disclose nonpublic information to the investor.

It may be unlikely that the Supreme Court would flatly state that a lender owes no duty of disclosure to an investor because of circumstances similar to those that existed in *Monsen*.¹⁶⁵ Further, even if the Supreme Court narrowly defined the circumstances under which a lender would have to disclose, unless the court were also to apply a standard stricter than the knew-or-should-have-known standard to seller and controlling person liability, a lender would still face the predicament described above. An interpretation of the securities acts consistent with the policy that the acts were designed to “protect investors with the least possible interference with honest business”¹⁶⁶ requires that both constructions of section 10(b) be made as suggested.

Responsible business practices require that lenders acquire knowledge about the activities of their borrowers. In turn, lenders have an obligation to safeguard such information as confidential.¹⁶⁷ Assuming that, in defined circumstances, a lender does owe a duty of disclosure to an investor, the lender is also faced with the question of what information must be disclosed as opposed to what information can be disclosed without violating its duty to the borrower. Judicial action to protect investors by expanding the catch-all net of section 10(b) to include lenders that knew or should have known of their borrower’s primary violation would cause lenders to face an increased risk that information gathered and disclosed to satisfy section 10(b) might be information the borrower considered confidential. Increased exposure to risk outside the securities acts would accordingly be reflected in higher loan costs.

Realize, too, that the costs incurred by a lender protecting itself from section 10(b) liability—inquiry and disclosure—will be passed on to the borrower in the form of higher loan costs.¹⁶⁸ If a lender is unable to pass on the costs associated with reducing its exposure to these liabilities, the lender will be hesitant or unwilling to finance borrowers who engage in securities transactions. The costs to society are apparent.

Conclusion

Uncertainty as to the nature of the duty that a financial institution supposedly owes to an investor to protect that investor from the securities law

165. 579 F.2d 793 (3d Cir.), cert. denied, 439 U.S. 930 (1978). *Monsen* is discussed *supra* at notes 88-92 and accompanying text.

166. S. REP. No. 47, 73d Cong., 1st Sess. (1933).

167. Lenders have been held liable for revealing financial records to private parties. See *Milohnich v. First Nat’l Bank*, 224 So. 2d 759, 760 (Fla. Dist. Ct. App. 1969); *Peterson v. Idaho First Nat’l Bank*, 83 Idaho 578, 583, 367 P.2d 284, 290 (1961); Note, *The Right to Financial Privacy Act and the SEC*, 39 WASH. & LEE L. REV. 1073 (1982).

168. To reduce both the risk and cost of a loan, a lender may want to assert varied forms of control over both the monies loaned and the activity of the borrower. As the amount of control increases, so does potential liability for being a controlling person.

violations of its borrower provided the source for this commentary. Theoretical certainty would be produced by defining that presumed duty by constructively imposing a qualified duty of inquiry and disclosure upon lenders. Seemingly, application of a knew-or-should-have-known standard in section 10(b) cases advances the investor protection policy of the securities acts. However, the resulting effects on the defenses to seller and controlling person liability, combined with the economic repercussions caused thereby, interfere with honest business. Thus, imposing a duty of inquiry and disclosure on lenders actually subverts the basic policy underlying the securities acts.¹⁶⁹

What has been developed as theory in this commentary threatens to become practice in the federal courts. The recent trend of strict interpretation of the securities acts, which the United States Supreme Court is promoting, indicates that inferior courts should be cognizant of the purposes Congress intended to accomplish by enacting the securities acts of 1933 and 1934. Recognition of Congress' intent demands that lenders do not and should not owe a duty to investors to protect them from the securities law violations of their borrowers.¹⁷⁰

David R. Cordell

169. See *supra* note 10.

170. The Ninth Circuit seems to be following the example set in *Wright v. Schock*, [1983-1984 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 99,411 (N.D. Cal. 1983). In *Montgomery v. Batt*, [1983-1984 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 97,647 (N.D. Cal. 1983), the court held that a financial consultant and a bank providing services to an investment company were not liable as aiders and abettors for nondisclosures even if they were aware of some improper practices because they were under no duty to disclose and because they did not render substantial assistance to the wrong. The only duty owed investors was to refrain from reckless or intentional misrepresentation.

In granting the defendants' motion for summary judgment, the court also found that the bank, which had maintained commercial checking accounts for the creator of trust deed investments, was not liable under section 12 since it was not an "offeror" or "seller" of a security and was neither in "privity" with the purchasers nor a "substantial factor" in the transaction.

Compare *Davis v. Avco Fin. Serv.*, 739 F.2d 1057 (6th Cir. 1984), where a lender and loan officer were held liable as sellers under section 12(2) because the loan officer participated in the promotion and sale of the "Dare to Be Great" scam. The lender, Avco, was held liable on a theory of respondeat superior. Special attention should be given to the considerations listed by the majority in analyzing whether a seller has established the affirmative defenses under section 12(2). See also the dissent by Justice Lively, 739 F.2d at 1069.

