



---

Summer 6-1-1985

## Liability of Financial Institutions for Aiding and Abetting Violations of Securities Laws

Sally Totten Gilmore

William H. McBride

Follow this and additional works at: <https://scholarlycommons.law.wlu.edu/wlulr>



Part of the [Securities Law Commons](#)

---

### Recommended Citation

Sally Totten Gilmore and William H. McBride, *Liability of Financial Institutions for Aiding and Abetting Violations of Securities Laws*, 42 Wash. & Lee L. Rev. 811 (1985).

Available at: <https://scholarlycommons.law.wlu.edu/wlulr/vol42/iss3/4>

This Article is brought to you for free and open access by the Washington and Lee Law Review at Washington and Lee University School of Law Scholarly Commons. It has been accepted for inclusion in Washington and Lee Law Review by an authorized editor of Washington and Lee University School of Law Scholarly Commons. For more information, please contact [christensena@wlu.edu](mailto:christensena@wlu.edu).

# LIABILITY OF FINANCIAL INSTITUTIONS FOR AIDING AND ABETTING VIOLATIONS OF SECURITIES LAWS

SALLY TOTTEN GILMORE\*  
WILLIAM H. McBRIDE\*\*

Financial institutions recently have faced numerous lawsuits for allegedly aiding and abetting violations of the federal securities law. The authors hope their proposed model will balance the rights and obligations of the respective parties as well as the need for a consistent but fair approach based on economic realities.

Liability for aiding and abetting arises from the knowing and substantial assistance of the commission of a securities law violation.<sup>1</sup> The action or inaction of the secondary defendant (the aider and abettor) must have assisted the primary violator's wrongdoing, and the secondary defendant must have known of both the commission of the underlying violation and his own role in the matter.<sup>2</sup> The aider's and abettor's assistance need not have caused the plaintiff's loss but the assistance must have been substantial in order for a court to impose liability.<sup>3</sup>

Aiding and abetting liability in the securities arena is a hybrid of statutory basis and judicial imposition.<sup>4</sup> This article will discuss the statutory basis for aiding and abetting liability and the judicial action that has led to the imposition of liability on financial institutions in civil actions for damages.<sup>5</sup>

## I. DISTINCTION OF AIDING AND ABETTING LIABILITY FROM OTHER FORMS OF SECURITIES LAW LIABILITY

### A. *Distinction between Primary and Secondary Liability*

Primary and secondary liability must be distinguished to understand fully the scope of, and policy and reasoning behind, secondary liability. Primary

---

\* Hunton & Williams, Raleigh, North Carolina; member of North Carolina Bar.

\*\* Hunton & Williams, Raleigh, North Carolina; member of North Carolina, Virginia and Texas Bars.

1. See generally Woodward v. Metro Bank, 522 F.2d 84 (5th Cir. 1975); Brennan v. Midwestern United Life Ins. Co., 259 F. Supp. 673 (N.D. Ind. 1966), *aff'd*, 417 F.2d 147 (7th Cir. 1969), *cert. denied*, 397 U.S. 989 (1970).

2. See generally Woodward v. Metro Bank, 522 F.2d 84 (5th Cir. 1975); Brennan v. Midwestern United Life Ins. Co., 259 F. Supp. 673 (N.D. Ind. 1966), *aff'd*, 417 F.2d 147 (7th Cir. 1969), *cert. denied*, 397 U.S. 989 (1970).

3. Landy v. FDIC, 486 F.2d 139, 162-71 (3d Cir. 1973), *cert. denied*, 416 U.S. 960 (1974).

4. Neither the Securities Act of 1933 (the "Securities Act") nor the Securities Exchange Act of 1934 (the "Exchange Act") specifically provide for aiding and abetting liability but 18 U.S.C. § 2(a) (1982) provides that an aider and abettor of a violation of federal law is punishable as a principal.

5. *Id.* See, e.g., Brennan v. Midwestern United Life Ins. Co., 259 F. Supp. 673 (N.D.

liability arises from the alleged wrongdoer's direct violation of a duty owed to the investing public under the securities laws. Secondary liability (of which aiding and abetting is one type) arises from the secondary defendant's involvement with another wrongdoer's direct violation rather than from a direct securities law violation by the secondary defendant. The doctrine of secondary liability holds a defendant liable to the same extent as the primary wrongdoer. In criminal law terms, the aider and abettor, as a person found secondarily liable, is "punishable as a principal."<sup>6</sup>

The recent development of the "fraud on the market" theory is an expansion of primary liability and is distinct from aiding and abetting liability. A hypothetical example is helpful. Assume that the president of ABC Corporation issues a press release to shareholders which includes a material overstatement of the corporation's net income for the year. At the same time, an investor decides to purchase shares of ABC Corporation's common stock because he hears that the corporation has just landed a long-term government contract. When the actual net income is released, the value of the stock falls substantially and the investor now wants to sue the corporation and the president. Under a conservative legal approach, the investor will encounter difficulty in establishing reliance upon the misstated financial information in the press release. The investor had not read the release and did not purchase the stock on that basis. Under the fraud on the market theory, however, the investor may be able to establish causation. The fact that the press release inflated the market value of the stock at the time of the investor's purchase would be decisive. Courts adopting the fraud on the market theory view the misrepresentation as the actual cause of the plaintiff's loss. These courts do not require that the misrepresentation be a factor in the plaintiff's decision to purchase the security but instead require that the misrepresentation be a factor in the artificial inflation of the security's value.

Aiding and abetting liability would arise in this hypothetical situation only if a third party aids and abets the president's actions. The fraud on the market theory does not extend liability to additional persons but instead expands the concept of the principal violations that a secondary defendant can aid or abet. For example, if a newspaper publisher knew that ABC Corporation's net income was overstated but published that information anyway, the publisher may be liable for aiding and abetting the president's actions under this theory.

### B. *Distinction between Various Forms of Secondary Liability*

Several forms of secondary liability exist which are different from aiding

---

Ind. 1966), *aff'd*, 417 F.2d 147 (7th Cir. 1969), *cert. denied*, 397 U.S. 989 (1970); see also Ruder, *Multiple Defendants in Securities Law Fraud Cases: Aiding and Abetting, Conspiracy, In Pari Delicto, Indemnification and Contribution*, 120 U. PA. L. REV. 597 (1972).

6. 18 U.S.C. § 2(a) (1982). See *infra* notes 29-35 *infra* and accompanying text (discussing history of aiding and abetting liability).

and abetting liability: 1) liability as a "controlling person" under Section 15 of the Securities Act<sup>7</sup> or Section 20 of the Exchange Act;<sup>8</sup> 2) liability under the doctrine of respondeat superior or an agency theory;<sup>9</sup> and 3) liability for conspiracy to commit a securities law violation.<sup>10</sup> The first form of secondary liability arises under the specific terms of the statute but the other two forms have been imposed judicially.<sup>11</sup> Although this article addresses only potential aiding and abetting liability, the other forms of secondary liability will be summarily discussed to provide the necessary framework within which the securities laws operate.

### 1. Liability as a Controlling Person

Section 15 of the Securities Act imposes liability on "controlling persons" for the acts of persons over whom they have control unless the controlling person has no reason to know of the facts giving rise to the liability of the controlled person.<sup>12</sup> This Section 15 "no reason to believe" standard which prevents imposition of liability on the secondary defendant contrasts with the "knowing and substantial assistance" standard which imposes liability on the aider and abettor.<sup>13</sup> A defendant can more easily escape liability under the Section 15 standard than under the standard for aiding and abetting. As a consequence, most plaintiffs allege aiding and abetting the underlying violation either instead of, or in addition to, controlling person liability under Section 15.

Section 20 of the Exchange Act is very similar to Section 15 of the Securities Act.<sup>14</sup> In slight contrast, however, Section 20 allows a defense if

7. 15 U.S.C. § 77 (1976); *see infra* notes 12-18 and accompanying text (discussing controlling person liability).

8. 15 U.S.C. § 78t (1982).

9. *See infra* notes 19-20 and accompanying text.

10. *See infra* notes 21-26 and accompanying text.

11. *See* 15 U.S.C. §§ 77o and 78t (1976) (only controlling person liability is specifically authorized by statute).

12. *See* 15 U.S.C. § 77o (1982). Section 15 of the Securities Act provides:

Every person who, by or through stock ownership, agency, or otherwise, or who, pursuant to or in connection with an agreement or understanding with one or more other persons by or through stock ownership, agency, or otherwise, controls any person liable under [sections 11 or 12], shall also be liable jointly and severally with and to the same extent as such controlled person to any person to whom such controlled person is liable, unless the controlling person had no knowledge of or reasonable ground to believe in the existence of facts by reason of which the liability of the controlled person is alleged to exist.

What constitutes control over the violator within the meaning of this statute is a factual question. *See Ferrara & Sanger, Derivative Liability in Securities Law: Controlling Person Liability; Respondeat Superior, and Aiding and Abetting*, 40 WASH. & LEE L. REV. 1007, 1009-11 (1983) (overview of control standard).

13. *See infra* notes 121-79 and accompanying text (knowing and substantial assistance of a securities law violation is basic element of aiding and abetting cause of action).

14. *See* 15 U.S.C. § 78t (1982). Section 20 of the Exchange Act provides:

(a) Every person who, directly or indirectly, controls any person liable under any

the controlling person "acted in good faith and did not directly or indirectly induce the act or acts constituting the violation or cause of action."<sup>15</sup> This defense is even less difficult to establish than the "no reason to believe" defense of Section 15 of the Securities Act. Plaintiffs' preference for aiding and abetting actions rather than "controlling person" actions is true notwithstanding that Sections 15 and 20 both place the burden of proof on the defendant whereas the burden of proof in an aiding and abetting cause of action is on the plaintiff.<sup>16</sup> In most cases involving violations of the Exchange Act, however, knowledgeable plaintiffs will seek actions under Section 10(b) of the Exchange Act rather than under Section 20.

Most courts have rejected the argument that Sections 15 and 20 are the exclusive provisions under which alleged aiders and abettors may be reached although the argument has been the source of much commentary.<sup>17</sup> Some courts do, however, use these sections as indicators of the limited nature of the securities laws in response to the everlasting attempt by plaintiffs to broaden the scope of the securities laws.<sup>18</sup>

---

provision of this chapter or of any rule or regulation thereunder shall also be liable jointly and severally with and to the same extent as such controlled person to any person to whom such controlled person is liable, unless the controlling person acted in good faith and did not directly or indirectly induce the act or acts constituting the violation or cause of action.

(b) It shall be unlawful for any person, directly or indirectly, to do any act or thing which it would be unlawful for such person to do under the provisions of this chapter or any rule or regulation thereunder through or by means of any other person.

(c) It shall be unlawful for any director or officer of, or any owner of securities issued by, any issuer required to file any document, report, or information under this chapter or any rule or regulation thereunder without just cause to hinder, delay, or obstruct the making or filing of any such document, report, or information.

*Id.*

15. *Id.* The relationships constituting control under the Exchange Act are similar to those constituting control under the Securities Act. *See supra* note 13. *Herm v. Stafford*, 663 F.2d 669 (6th Cir. 1981) (examination of control under Exchange Act regarding director of corporation).

16. *See Ruder, supra* note 5, at 602.

17. The fact that the same circumstances often give rise to both allegations under the controlling person provisions and allegations of other secondary liability is a basis for the argument that Sections 15 and 20 should be the exclusive remedies against secondary defendants. Although this argument has met with some agreement from the courts with regard to actions under the doctrine of respondeat superior, conspiracy and aiding and abetting cases abound. *See Zweig v. Hearst Corp.*, 521 F.2d 1129 (9th Cir.), *cert. denied*, 423 U.S. 1025 (1975); *Burks v. Lasker*, 441 U.S. 471, 478 (1979) (not all existing state law is replaced by the federal securities laws); *see also Ferrara & Sanger, supra* note 12, at 1017-22; Fischel, *Secondary Liability under Section 10(b) of the Securities Act of 1934*, 69 CAL. L. REV. 80 (1981); *Ruder, supra* note 5.

18. This has been the approach of the Third and Ninth Circuits. *See, e.g., Rochez Brothers Inc. v. Rhoades*, 527 F.2d 880 (3d Cir. 1975), *cert. denied*, 425 U.S. 993 (1976); *Zweig v. Hearst Corp.*, 521 F.2d 1129 (9th Cir.), *cert. denied*, 423 U.S. 1025 (1975); *cf. Sharp v. Coopers & Lybrand*, 649 F.2d 175 (3d Cir. 1981), *cert. denied*, 455 U.S. 938 (1932) (broker-dealer exception).

## 2. Respondeat Superior

The doctrine of respondeat superior has been invoked in the securities context against employers and certain other principals for unlawful acts of their employees or agents. An employer, for example, may be liable for actions taken by his employee acting within the scope of his or her employment, or a principal may be liable for actions taken by an agent acting within the scope of his actual or apparent authority.<sup>19</sup> In contrast with controlling person liability, the doctrine of respondeat superior is not based upon the employer's or principal's failure to supervise its employee or agent.<sup>20</sup> Thus, the defenses of due diligence and good faith are unavailable.<sup>21</sup> Respondeat superior is a form of strict liability of the employer or principal and so plaintiffs favor this doctrine over actions under the controlling person sections of the securities statutes. Respondeat superior is even favored over causes of action based on aiding and abetting, but its limitations in particular employer and principal situations results in the doctrine's comparatively infrequent use.

## 3. Conspiracy

Under a conspiracy theory, a defendant is liable if he agrees with another to commit a securities violation and some overt act in furtherance of the violation is taken.<sup>22</sup> A conspiracy is the agreement of two or more persons to accomplish an unlawful purpose or a lawful purpose by unlawful means.<sup>23</sup> By contrast, aiding and abetting involves the assistance to a primary violator in the violator's accomplishment of either an unlawful purpose or a lawful purpose by unlawful means. The distinction is that conspiracy requires an agreement. As the Supreme Court succinctly stated in a tax evasion case:

The gist of the conspiracy is the agreement; that of aiding, abetting or counseling is in consciously advising or assisting another to commit particular offenses, and thus becoming a party to them; that of substantive crime, going a step beyond mere aiding, abetting, counseling to completion of the offense.<sup>24</sup>

Conspiracy theory is often confused with aiding and abetting theory.<sup>25</sup>

---

19. RESTATEMENT (SECOND) OF AGENCY §§ 219, 257, 261 (1958); see Ferrara & Sanger, *supra* note 12, at 1015-1022.

20. RESTATEMENT (SECOND) OF AGENCY §§ 219, 257, 261 (1958); 3 AM. JUR. 2D Agency § 261 (1962).

21. See *supra* note 20.

22. See Fischel, *supra* note 17; Ruder, *supra* note 5; R. PERKINS, CRIMINAL LAW 527-34 (3d ed. 1982).

23. R. PERKINS, *supra* note 22, at 528.

24. Pinkerton v. U.S., 328 U.S. 640, 649 (1946).

25. Both conspiracy and aiding and abetting require cooperation in an unlawful scheme. Conspiracy, however, requires an agreement whereas aiding and abetting requires knowing and substantial assistance. The distinctions in particular situations can be difficult to determine but the differences are important, particularly for pleading purposes. This is especially true in

Especially in cases in which the defendant's conduct is more culpable, plaintiffs allege both conspiracy and aiding and abetting. The confusion of the two theories stems from the specific statutory language prohibiting unlawful fraudulent schemes, particularly in Section 10(b) cases. The direct involvement of a participant in an unlawful scheme should give rise to a conspiracy action, whereas aiding and abetting liability should arise from the assistance given by a secondary party to a direct participant. Because courts will not impose aiding and abetting liability unless the defendant knows of his role in the overall improper conduct,<sup>26</sup> the alleged aider and abettor will be fairly culpable. Whether this culpability rises to the level of conspiracy is an issue not fully examined in most cases. Perhaps courts recognize the potential procedural and practical problems created by attempting to draw this fine line and see no reason to confront the question. In most situations where the issue may arise the defendant's actions generally at least constitute aiding and abetting and so the defendant will be liable to the plaintiff regardless of the underlying rationale.

## II. AIDING AND ABETTING LIABILITY EXPLAINED

Aiding and abetting a securities law violation entails the knowing and substantial assistance of another's commission of a securities law violation. Unlike the provision of the Investment Advisers Act of 1940 which specifically prohibits aiding, abetting, counseling, commanding, inducing or procuring a violation of that act and authorizes the federal courts to enjoin such actions,<sup>27</sup> neither the Securities Act nor the Exchange Act specifically address aiding and abetting. Both acts impose liability on persons controlling the violator<sup>28</sup> but neither authorize either an injunctive procedure or a private action for damages by an injured investor against an aider and abettor.

### A. History

Title 18, Section 2(a) of the United States Code states that "[w]hoever commits an offense against the United States or aids, abets, counsels, commands, induces or procures its commission, is punishable as a principal."<sup>29</sup> This section has been used in connection with injunctive procedures brought by the Securities and Exchange Commission (the SEC).<sup>30</sup> The

---

securities fraud cases because fraud must be pleaded with particularity. FED. R. CIV. PRO. 9(b).

26. See *infra* notes 102-120 and 166-79 and accompanying text (knowledge of both the underlying violation and the actor's role in the scheme is necessary).

27. 15 U.S.C. § 80b-9(e) (1982).

28. 15 U.S.C. §§ 77o & 78t (1982).

29. 18 U.S.C. § 2(a) (1982). See Note, *Secondary Liability of Attorneys for Securities Law Violations—The Need for a Single Standard of Attorney Conduct*, 30 WAYNE L. REV 65 (1983).

30. SEC v. Scott Taylor & Co., 183 F. Supp. 904 (S.D.N.Y. 1959); SEC v. Timetrust, Inc., 28 F. Supp. 34 (N.D. Cal. 1939), *rev'd in part on other grounds*, 142 F.2d 744 (9th Cir. 1944).

language of Section 2(a) is directed at criminal violations and speaks in terms of punishment. Courts have granted injunctions against aiders and abettors<sup>31</sup> and presumably will impose criminal penalties for a violation of such injunctions. Section 2(a) of Title 12, however, is far from binding authority for allowing a private action against aiders and abettors for damages.

In 1959, Congress considered and rejected an amendment to the securities acts specifically drafted to include aiding and abetting as a direct violation of those acts.<sup>32</sup> One of the stated purposes of the bill was "to strengthen and clarify the injunctive power" rather than to add a new element to the power of the SEC.<sup>33</sup> Notwithstanding this defeat, courts still allow private actions.<sup>34</sup> Although the amendment was only one of many amendments offered by the SEC, its defeat is the only statement of Congressional intent in this area.<sup>35</sup>

In the landmark case of *Timetrust, Inc. v. SEC*,<sup>36</sup> the district court issued an injunction against various defendants participating in an unlawful distribution of stock, including certain salesmen and others who allegedly aided and abetted this distribution.<sup>37</sup> The court of appeals reversed a portion of the case on the evidence presented but the theory of aiding and abetting remained intact.<sup>38</sup> In *SEC v. Scott Taylor & Co., Inc.*,<sup>39</sup> the district court found for the SEC on a conspiracy theory in an injunctive proceeding.

One of the more important early cases was *Brennan v. Midwestern United Life Insurance Co.*<sup>40</sup> In *Brennan*, the district court rejected the

31. *SEC v. Scott Taylor & Co.*, 183 F. Supp. 904 (S.D.N.Y. 1959); *SEC v. Timetrust, Inc.*, 28 F. Supp. 34 (N.D. Cal. 1939), *rev'd in part on other grounds*, 142 F.2d 744 (9th Cir. 1944).

32. See *Hearing Before a Subcommittee of the Senate Committee on Banking and Currency*, 86th Cong., 1st Sess. 275-76 (1959); *Hearings Before the House Committee on Interstate and Foreign Commerce*, 86th Cong., 1st Sess. 93, 103 (1959). See also S. REP. No. 1757, 86th Cong., 2d Sess. 9 (1960).

33. See S. REP. No. 1757, 86th Cong., 2d Sess. 8 (1960).

34. *Brennan v. Midwestern United Life Ins. Co.*, 259 F. Supp. 673 (N.D. Ind. 1966), *aff'd*, 417 F.2d 147 (7th Cir. 1969), *cert. denied*, 397 U.S. 989 (1970).

35. It should be noted that *SEC v. Scott Taylor & Co.*, *Fry v. Schumacker*, and *SEC v. Timetrust, Inc.* had already been decided at the time Congress defeated the amendment that would have included aiding and abetting as a direct violation of the securities laws. *SEC v. Scott Taylor & Co.*, 183 F. Supp. 904 (S.D.N.Y. 1959); *Fry v. Schumacker*, 83 F. Supp. 476 (E.D. Pa. 1947); *SEC v. Timetrust, Inc.*, 28 F. Supp. 34 (N.D. Cal. 1939), *rev'd in part*, 142 F.2d 744 (9th Cir. 1944). Both *Scott Taylor* and *Timetrust*, however, were injunctive proceedings by the SEC and neither involved private civil actions. See *infra* text accompanying notes 36-39 (discussing *Scott Taylor* and *Timetrust*). In addition, the proposed but unadopted Federal Securities Code includes a section specifically prohibiting aiding or abetting a violation of that code. ALI, Federal Securities Code § 1724(b) (Proposed Official Draft 1978). See generally Comment, *Attorneys and Participant Liability under Section 12(2) of the Securities Act of 1933*, 1982 ARIZ. ST. L. J. 529.

36. 28 F. Supp. 34 (N.D. Cal. 1939), *rev'd in part*, 142 F.2d 744 (9th Cir. 1944).

37. *Id.*

38. *Timetrust v. SEC*, 142 F.2d 744 (9th Cir. 1944).

39. 183 F. Supp. 904 (S.D.N.Y. 1959).

40. 259 F. Supp. 673 (N.D. Ind. 1966), *aff'd*, 417 F.2d 147 (7th Cir. 1969), *cert. denied*, 397 U.S. 989 (1970).



argument that the failure of the bill which included aiding and abetting as a direct violation necessarily negates the existence of aiding and abetting liability.<sup>41</sup> In *Brennan*, the court allowed a private action against the issuer of securities who allegedly aided and abetted a broker-dealer's violation of Section 10(b) by advising persons who complained of the broker-dealer's actions to settle the matter directly with the broker-dealer. The issuer of securities also failed to report the broker-dealer to the Indiana Securities Commission and the SEC after the issuer received the complaints. The court cited with approval Restatement of Torts Section 876 which deals with harm resulting to a third person from the tortious conduct of persons acting in concert.<sup>42</sup> The *Brennan* court approved of the abolition in Section 876 of any privity requirement that may have existed prior to the drafting of that section.<sup>43</sup>

The importance of *Brennan* stems from the Seventh Circuit's approval of the aiding and abetting action in fairly broad terms. The court of appeals stated that but for the encouragement by the issuer of the securities, the broker-dealer would have ceased his violations or would have been forced to do so by the Indiana Securities Commission or the SEC.<sup>44</sup> One judge wrote a vituperative dissent on the lack of evidence but agreed as to the plaintiff's ability to recover on an aiding and abetting theory.<sup>45</sup>

From this leading case, many others followed. In *Landy v. FDIC*,<sup>46</sup> the Third Circuit set forth three elements to establish liability: (1) an independent wrong must exist; (2) the aider or abettor must know of that wrong's existence; and (3) substantial assistance must be given in effecting that wrong.<sup>47</sup>

41. See S. REP. No. 1757, 86th Cong., 2d Sess. (1960) (bill was comprehensive package of amendments for both Securities Act and Exchange Act). The Brennan court noted that three cases had already decided this issue, *SEC v. Scott Taylor & Co.*, 183 F. Supp. 904 (S.D.N.Y. 1959); *Fry v. Schumacher*, 83 F. Supp. 476 (E.D. Pa. 1947); *Timetrust, Inc. v. SEC*, 28 F. Supp. 34 (N.D. Cal. 1939), *rev'd in part on other grounds*, 142 F.2d 744 (9th Cir. 1944), and that other amendments were offered in the bill as well. The bill was a comprehensive package of amendments for both the Securities Act and the Exchange Act. See S. REP. No. 1757, 86th Cong., 2d Sess. (1960).

42. 259 F. Supp. at 680. RESTATEMENT OF TORTS § 876 provides:

For harm resulting to a third person from the tortious conduct of another, a person is liable if he

- (a) orders or induces such conduct, knowing of the conditions under which the act is done or intending the consequences which ensue, or
- (b) knows that the other's conduct constitutes a breach of duty and gives substantial assistance or encouragement to the other so to conduct himself, or
- (c) gives substantial assistance to the other in accomplishing a tortious result and his own conduct, separately considered, constitutes a breach of duty to the third person.

RESTATEMENT OF TORTS § 876 (1939).

43. 259 F. Supp. at 680.

44. 417 F.2d at 153-155.

45. See *id.* at 155 (Judge Morgan stated he would concur in decision if he could find any evidence to support it).

46. 486 F.2d 139 (3d Cir. 1973), *cert. denied*, 416 U.S. 960 (1974). See *infra* notes 120-23 and accompanying text (discussing *Landy*).

47. *Landy v. FDIC*, 486 F.2d 139, 162-63 (3d Cir. 1973), *cert. denied*, 416 U.S. 960

In *Woodward v. Metro Bank*,<sup>48</sup> the court of appeals further refined the elements of the cause of action. In this case, plaintiff co-signed a promissory note pledging certain stock as collateral "against all indebtedness now owing or which may hereafter become owing" by the debtor to the defendant bank. The plaintiff believed that the debtor was a corporation but the loan was actually made to one of the corporation's officers who in turn deposited the loan proceeds in the corporation's account. The bank sought payment from the plaintiff when the officer defaulted on subsequent indebtedness. The Fifth Circuit rejected the *Landy* court's requirement of the existence of an independent wrong in favor of the existence of an underlying securities violation to ensure a sufficient nexus with the securities laws.<sup>49</sup> The *Woodward* court also rejected the *Landy* requirement of the aider's and abettor's knowledge of the wrong's existence in favor of a general awareness of one's role in an overall improper activity.<sup>50</sup> In *Woodward*, the district court dismissed the suit because the bank's loan was not a "sale" within the meaning of the Exchange Act and the loan was exempted under Section 3(a)(10) as short-term commercial paper.<sup>51</sup> The court of appeals affirmed but on different grounds. The Fifth Circuit's decision was based on the lack of any substantial assistance by the alleged aiders and abettors in the primary Section 10(b) violations.

### B. *Elements of Aiding and Abetting a Securities Law Violation*

To recapitulate, aiding and abetting liability is a form of secondary liability separate and distinct from liability for the underlying violation. Although courts vary in their articulation of the elements of aiding and abetting liability, generally the following three elements must be present: (1) an underlying securities law violation by a third party; (2) the defendant's knowledge of that underlying violation; and (3) the defendant's knowing and substantial assistance in the third party's commission of the underlying violation.<sup>52</sup>

#### 1. Underlying Violation

The first element, the underlying violation, caused much confusion in

---

(1974).

48. 522 F.2d 84 (5th Cir. 1975).

49. *Id.* at 86-87.

50. *Id.*

51. *Id.* at 86-87. Section 3(a)(10) of the Exchange Act provides an exemption for notes with a maturity of nine months or less. 15 U.S.C. § 78c(a)(10) (1982). The district court's opinion is unpublished.

52. The elements of aiding and abetting liability are the compilation of a number of different cases. *Harmsen v. Smith*, 693 F.2d 932, 943 (9th Cir. 1982), *cert. denied*, 464 U.S. 822 (1983); *Woodward v. Metro Bank*, 522 F.2d 84, 92 (5th Cir. 1975); *Landy v. FDIC*, 486 F.2d 139, 163-65 (3d Cir. 1973), *cert. denied*, 416 U.S. 960 (1974); *H.L. Federman & Co. v. Greenberg*, 405 F. Supp. 1332, 1336-38 (S.D.N.Y. 1975).

the early aiding and abetting cases.<sup>53</sup> The courts often failed to distinguish primary from secondary violations<sup>54</sup> and also failed to distinguish among the various forms of secondary liability.<sup>55</sup> The more recent decisions emphasize the necessity of a principal underlying violation that the defendant could have aided and abetted.<sup>56</sup>

The underlying violation may be any violation of the Securities Act or the Exchange Act.<sup>57</sup> Because the bulk of the cases have arisen under Sections 12<sup>58</sup> and 17<sup>59</sup> of the Securities Act and Section 10 of the Exchange Act,<sup>60</sup> these are the only sections that will be discussed at any length herein.<sup>61</sup>

---

53. See *supra* notes 26-27 and accompanying text (confusion regarding requirement of underlying violation may have arisen in part due to statutory language of Section 10(b) of Exchange Act prohibiting certain fraudulent schemes). The causation requirement probably also contributed to the confusion in the early aiding and abetting cases. The aider's and abettor's conduct need not have been a cause of the plaintiff's loss but the aider's and abettor's conduct must have aided the primary violator's unlawful conduct. The primary violator's actions must have been a cause of the loss. See *Rosen v. Dick*, [1974-1975 Transfer Binder] FED. SEC. L. REP. (CCH) 94,786 (S.D.N.Y. 1974); see also *infra* notes 118-64 and accompanying text (discussing knowing and substantial assistance element).

54. See, e.g., *Rolf v. Blyth, Eastman Dillon & Co.*, 570 F.2d 38 (2d Cir. 1978), cert. denied, 439 U.S. 1039 (1978). In *Rolf*, where plaintiff's registered representative was held liable for aiding and abetting the plaintiff's investment adviser's misconduct. *Id.* The *Rolf* court applied Woodward's three-pronged analysis of aiding and abetting liability but also used such language as "[the defendant] participated in and lent assistance to the fraud." *Id.* at 44 (emphasis added).

55. See, e.g., *Pettit v. American Stock Exchange*, 217 F. Supp. 21 (S.D.N.Y. 1963). In *Pettit*, the court decided the case on a conspiracy theory but cited *SEC v. Scott Taylor & Co.* as support for liability for the knowing assistance or participation in an unlawful scheme under Section 10(b) of the Exchange Act. *Id.*; *SEC v. Scott Taylor & Co.*, 183 F. Supp. 909, 909 n.12 (S.D.N.Y. 1959). The footnote cited, however, only referred to aiding and abetting liability. See 183 F. Supp. at 909 n.12.

56. See, e.g., *Cleary v. Perfecture*, 700 F.2d 774 (1st Cir. 1983); *IIT v. Cornfeld*, 619 F.2d 909 (2d Cir. 1980); *Woodward v. Metro Bank*, 522 F.2d 84 (5th Cir. 1974).

57. The underlying violation which supports aiding and abetting liability may also be a violation of another act or a stock exchange rule. See *Rolf v. Blyth, Eastman Dillon & Co.*, 570 F.2d 38 (2d Cir. 1978). This article, however, is concerned only with violations of these two acts. Violations under other acts such as the Trust Indenture Act of 1939 are not considered here. In addition, only sections under which a private cause of action for a primary violation is allowed justify a private action against a secondary defendant. Thus there would be no liability for aiding and abetting under the antifraud provisions of the Investment Advisers Act of 1940, since there is no private federal cause of action under that statute. 15 U.S.C. § 80b-6 (1982). See *Transamerica Mortgage Advisers v. Lewis*, 444 U.S. 11, 19-24 (1979).

58. 15 U.S.C. § 771 (1982). See *infra* notes 62-85 and accompanying text (discussing aiding and abetting cases under Section 12 of Securities Act).

59. 15 U.S.C. § 77q (1982). See *infra* notes 86-91 and accompanying text (discussing aiding and abetting cases under Section 17 of Securities Act).

60. 15 U.S.C. § 82 (1982). See *infra* notes 92-101 and accompanying text (discussing aiding and abetting cases under Section 10 of Exchange Act).

61. Private actions are also granted under other sections of the securities acts other than Sections 12 and 17 of the Securities Act and Section 10 of the Exchange Act. See, e.g., *In re Caesar's Palace Sec. Litig.*, 360 F. Supp. 366 (S.D.N.Y. 1973). *Caesar's Palace* dealt with aiding and abetting liability under Section 11 of the Securities Act but this case was overruled in *In re Flight Transportation Corporation Securities Litigation* in light of the Supreme Court's decision

a. *Section 12 of the Securities Act*

Technically Section 12 of the Securities Act only grants the purchaser a right of rescission of his purchase, or an action for damages if the purchaser has sold his security, against the seller if the security in question was offered or sold in violation of Section 5<sup>62</sup> or pursuant to a false or misleading prospectus.<sup>63</sup> By the specific terms of this section, no secondary liability is

in *Huddleston v. Herman & MacLean*. [1984 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 91,622 (D. Minn. 1984); *Huddleston v. Herman & MacLean*, 459 U.S. 375 (1983) (stating that Section 11 actions may only be brought against parties specifically set forth in the statute). Section 11 sets forth very specific remedies against very specific parties and several courts have held that no private action for aiding and abetting a violation of that section exists. *See* 15 U.S.C. § 77k (1982); *In re Flight Transportation Corp. Sec. Litig.* [1984 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 91,622 (D. Minn. 1984); *Hagert v. Glickman, Lurie, Eiger & Co.*, 520 F. Supp. 1028 (D. Minn. 1981); *In re Equity Funding Corp. of Am. Sec. Litig.*, 416 F. Supp. 161, 181 (C.D. Cal. 1976). *But see* SEC v. Seaboard Corp., 677 F.2d 1301 (9th Cir. 1982) (SEC injunctive proceeding). The plaintiff in *Rolf v. Blyth, Eastman* sought an action under New York Stock Exchange Rule 405 ("Know Thy Customer Rule" requiring that securities purchased based on broker-dealers' investment advice be suitable for the customer) but the Second Circuit did not reach the issue. *Rolf v. Blyth, Eastman Dillon & Co.*, 570 F.2d 38 (2d Cir. 1978), *cert. denied*, 439 U.S. 1039 (1978). Courts have rejected private aiding and abetting actions under Section 15 of the Exchange Act. 15 U.S.C. § 78o (1982). *See, e.g.*, SEC v. Seaboard Corp., 677 F.2d 1301, 1313-14 (9th Cir. 1982) (private action against accountants for allegedly aiding and abetting a violation of Section 15 are specifically prohibited).

62. 15 U.S.C. § 77e (1982). Section 5 of the Securities Act prohibits "gun-jumping" in the sale of a security and imposes certain other requirements in the offer or sale of a security. Section 5 provides:

- (a) Unless a registration statement is in effect as to a security, it shall be unlawful for any person, directly or indirectly
  - (1) to make use of any means or instruments of transportation or communication in interstate commerce or of the mails to sell such security through the use or medium of any prospectus or otherwise; or
  - (2) to carry or cause to be carried through the mails or in interstate commerce, by any means or instruments of transportation, any such security for the purpose of sale or for delivery after sale.
- (b) It shall be unlawful for any person, directly or indirectly
  - (1) to make use of any means or instruments of transportation or communication in interstate commerce or of the mails to carry or transmit any prospectus relating to any security with respect to which a registration statement has been filed under this subchapter, unless such prospectus meets the requirements of section 77j of this title; or
- (c) It shall be unlawful for any person, directly or indirectly, to make use of any means or instruments of transportation or communication in interstate commerce or of the mails to offer to sell or offer to buy through the use or medium of any prospectus or otherwise any security, unless a registration statement has been filed as to such security, or while the registration statement is the subject of a refusal order or stop order or (prior to the effective date of the registration statement) any public proceeding or examination under section 77h of this title.

15 U.S.C. § 77e (1982).

63. 15 U.S.C. § 77l (1982). Section 12 provides:

Any person who—

- (1) offers or sells a security in violation of Section [5] of this title, or

imposed, and privity is required. Notwithstanding the section's legislative history, some courts have judicially imposed secondary liability under one of two theories. The first theory is an expanded concept of the meaning of seller under this section.<sup>64</sup> The second theory imposes aiding and abetting liability on defendants other than the actual seller.<sup>65</sup> Both approaches, although perhaps consistent with the overall policy of the securities acts, are contrary to both the language and legislative history of Section 12.

The Fifth Circuit has adopted an expanded reading of the term "seller" under Section 12 of the Securities Act, examining whether the defendant was a proximate cause or substantial factor in causing the transaction to occur.<sup>66</sup> In *Pharo v. Smith*,<sup>67</sup> the Fifth Circuit stated that "in complex securities transactions, the true seller is not necessarily the person who transfers title, so other participants in the sale can, also, be treated as sellers."<sup>68</sup> The court distinguished between a strict privity requirement and an overbroad participation theory and viewed its approach as a middle ground.<sup>69</sup>

In addition, the *Pharo* court distinguished between subsections (1) and

(2) offers or sells a security (whether or not exempted by the provisions of Section (2) of Subsection (a) of said section), by the use of any means or instruments of transportation or communication in interstate commerce or of the mails, by means of a prospectus or oral communication, which includes an untrue statement of a material fact or omits to state a material fact necessary in order to make the statements, in the light of the circumstances under which they were made, not misleading (the purchaser not knowing of such untruth or omission), and who shall not sustain the burden of proof that he did not know, and in the exercise of reasonable care could not have known, of such untruth or omission,

shall be liable to the person purchasing such security from him, who may sue either at law or in equity in any court of competent jurisdiction, to recover the consideration paid for such security with interest thereon, less the amount of any income received thereon, upon the tender of such security, or for damages if he no longer owns the security.

15 U.S.C. § 771 (1982).

64. Section 12 only grants an action against the seller of a security. 15 U.S.C. § 771 (1982). The operative phrase in Section 12 states that the violator ". . . shall be liable to the person purchasing such security from him. . . ." *Id.* Expanding the meaning of this phrase imposes primary, not secondary, liability on others than the true seller. *See Comment, supra* note 35.

65. *See infra* text accompanying notes 78-79 (imposition of aiding and abetting liability on persons other than seller is form of secondary liability).

66. *Pharo v. Smith*, 621 F.2d 656 (5th Cir. 1980), *aff'd in part, rev'd in part on rehearing*, 625 F.2d 1226 (5th Cir. 1980); *see also Comment, supra* note 35.

67. 621 F.2d 656 (5th Cir. 1980), *aff'd in part, rev'd in part on rehearing*, 625 F.2d 1226 (5th Cir. 1980).

68. 621 F.2d at 665.

69. *Id.* at 665-67. In *Wonneman v. Stratford Sec. Co.*, the court required privity between the plaintiff and the seller and rejected plaintiff's theory that defendant's participation in the overall plan to market securities was sufficient to impose liability under Section 12(1). [1957-1961 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 91,034 (S.D.N.Y. 1961). *Wonneman*, however, was decided before private actions under Section 10(b) of the Exchange Act were allowed. Whether the *Wonneman* rationale would be followed today in the Second Circuit is unclear.

(2) of Section 12.<sup>70</sup> Subsection 12(1) imposes strict liability for the sale of an unregistered security but subsection 12(2) allows a defense if the seller did not know, and in the exercise of reasonable care could not have known, of the violation.<sup>71</sup> In subsection 12(1) cases, the court said it would be more unwilling to impose liability on one who is not the true seller. With this approach, a seller can be anyone who is in privity with the purchaser or who is a substantial factor in causing the transaction to occur.

The Eighth Circuit has examined the relationship of the defendant to the particular transaction in determining whether the defendant is a seller under Section 12.<sup>72</sup> Technically such an analysis is appropriate for secondary liability but not for primary liability.<sup>73</sup> The result is the same, however, in that liability is imposed on a party who is not the actual seller and primary violator. The actual seller and primary violator would also generally be reachable under Section 10(b) of the Exchange Act.<sup>74</sup>

The Eighth Circuit's approach seems clearly contrary to the language of the statute. Section 12 allows a right of rescission against the seller, or an action for damages if the plaintiff no longer owns the security, if there is an offer or sale of a security through the use of a misleading prospectus or in violation of Section 5.<sup>75</sup> The language is extremely narrow in contrast to the sweeping language of Section 10(b) of the Exchange Act.<sup>76</sup> In addition, in recent decisions the Supreme Court has indicated the importance of adhering

70. See *supra* note 63 (statutory language of Section 12).

71. *Id.*

72. See *Wasson v. SEC*, 558 F.2d 879, 886 (8th Cir. 1977). The Eighth Circuit stated that the key question was whether the defendant was in a unique position to ask relevant questions, acquire material information or disclose his findings. *Id.* The defendant's involvement in the transaction was only one of the factors that the court considered. *Id.* at 886-87.

73. The defendant's relationship to the transaction is a factor similar to the knowing and substantial assistance element of aiding and abetting liability. It examines the defendant's position in the transaction and not whether the defendant committed a primary violation.

74. See 15 U.S.C. § 78j(b) (1982). See *infra* notes 92-101 and accompanying text (discussion of Section 10(b)).

75. See 15 U.S.C. § 77i (1982), *supra* note 63 (text of Section 12 of Securities Act); 15 U.S.C. § 77e (1982); *supra* note 62 (Section 5 of Securities Act).

76. See 15 U.S.C. § 78j (1982). Section 10(b) of the Exchange Act provides:

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

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

*Id.* Section 10(b) of the Exchange Act refers generally to manipulative or deceptive practices in connection with the sale of a security, while Section 12 of the Securities Act refers to an offer

to the actual language of the statute and has been unwilling to embrace expansive liability.<sup>77</sup>

A second theory of secondary liability is used by courts that do not define expansively the term "seller" in Section 12 of the Securities Act. This second approach involves the application of aiding and abetting liability to defendants other than the true seller in Section 12 cases.<sup>78</sup> The basic theory is that aiders and abettors should be liable to plaintiffs under Section 12 to the same extent as the seller is liable.<sup>79</sup> As in all aiding and abetting cases, the three elements of aiding and abetting discussed above must be present before liability is imposed.<sup>80</sup> In *Tucker v. Janota*,<sup>81</sup> for example, the district court examined the role of two banks which loaned money for investors to invest in various real estate limited partnerships. The *Tucker* court considered the defendants' behavior with regard to possible aiding and abetting violations of Sections 12(1) and (2) of the Securities Act and Section 10(b) of the Exchange Act. The court held that a triable issue of fact existed under Section 12 as well as under Section 10(b). This approach, however, is also contrary to the section's language and legislative history.

As discussed above, Section 12 is a narrow remedy allowing recovery of the consideration paid or damages if the purchaser no longer owns the security.<sup>82</sup> This language implies recovery from the party to whom the consideration was paid, not recovery from any other party to the transaction. This section is unlike Section 11 which in general terms allows recovery of the difference between the amount paid for the security and its market value.<sup>83</sup> A Section 11 measure of damages is more closely akin to the measure

or sale of a security by the use of a misleading prospectus or oral communication or in violation of Section 5. *Id.*; 15 U.S.C. § 77i (1982).

77. See *infra* text accompanying notes 181-88.

78. *Tucker v. Janota*, [1979 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,701 (N.D. Ill. 1978). Under cases following this approach, the defendant is not treated as a seller but as a secondary defendant. This approach thus applies secondary liability analysis instead of the primary liability analysis discussed above. See *supra* text accompanying notes 66-74.

79. See *supra* text accompanying notes 29-31 and 46-51 (discussion of history and necessary elements of aiding and abetting).

80. See *supra* text accompanying notes 46-51.

81. [1979 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,701 (N.D. Ill. 1978). See *infra* text accompanying notes 155-56 (discussing *Tucker v. Janota*).

82. See 3 A. BROMBERG, SECURITIES LAW § 8.4(31o) (1981). Professor Bromberg has argued that Section 12 imposes liability but does not define a violation and that aiding and abetting is criminal in nature, connoting a separate violation. *Id.*

83. See 15 U.S.C. § 77k(e) (1982) (Section 11(e) of Securities Act). Section 11(e) of the Securities Act provides:

The suit authorized under subsection (a) of this section may be to recover such damages as shall represent the difference between the amount paid for the security (not exceeding the price at which the security was offered to the public) and (1) the value thereof as of the time such suit was brought, or (2) the price at which such security shall have been disposed of in the market before suit, or (3) the price at which such security shall have been disposed of after suit but before judgment if such damages shall be less than the damages representing the difference between the

of damages caused by an aider and abettor. The Section 12 rescissional measure of damages is the measure of damages one should recover from the seller of the security. It is difficult to imagine a situation where one can "recover the consideration paid" from one to whom no consideration was paid.

Aiding and abetting liability under Section 12 is also contrary to the section's legislative history. In 1960, Congress defeated a proposed amendment specifically drafted to include aiding and abetting as a direct violation of Section 12(2).<sup>84</sup> Although one should not read too much into such a defeat, the fact remains that Congress failed to enact such an amendment. The narrow remedy authorized and the failure of enactment in 1960 with no further attempt at enactment implies that secondary liability was not intended by Congress to be encompassed within the plain meaning of Section 12.<sup>85</sup>

*b. Section 17 of the Securities Act*

Section 17(a) of the Securities Act prohibits, in the offer or sale of a security, the employment of any device, scheme or artifice to defraud, the obtaining of money through the use of an untrue statement, the omission of a material fact which renders statements in the offering or sale misleading, and the use of a practice which may operate as a fraud or deceit upon the purchaser.<sup>86</sup> No scienter is required for a primary violation under subpara-

---

amount paid for the security (not exceeding the price at which the security was offered to the public) and the value thereof as of the time such suit was brought: *Provided*, That if the defendant proves that any portion or all of such damages represents other than the depreciation in value of such security resulting from such part of the registration statement with respect to which his liability is asserted, not being true or omitting to state a material fact required to be stated therein or necessary to make the statements therein not misleading, such portion of or all such damages shall not be recoverable. In no event shall any underwriter (unless such underwriter shall have knowingly received from the issuer for acting as an underwriter some benefit, directly or indirectly, in which all other underwriters similarly situated did not share in proportion to their respective interests in the underwriting) be liable in any suit or as a consequence of suits authorized under subsection (a) of this section for damages in excess of the total price at which the securities underwritten by him and distributed to the public were offered to the public.

*Id.*

84. See *Hearings Before a Subcommittee of the Senate Committee on Banking and Currency*, 86th Cong., 1st Sess. 275-76 (1959); *Hearings Before the House Committee on Interstate and Foreign Commerce*, 86th Cong., 1st Sess. 93,103 (1959). See also S. REP. NO. 1757, 86th Cong., 2d Sess. 9 (1960).

85. Principles of statutory construction dictate that the meaning of a statute should be gleaned from its plain meaning in its context. Only if the plain meaning of a statute is in question should a court need to refer to its legislative history. This is often referred to as the "plain meaning rule." *United States v. American Trucking Assoc.*, 310 U.S. 534 (1940).

86. See 15 U.S.C. § 77q (1982). Section 17 of the Securities Act provides:

(a) It shall be unlawful for any person in the offer or sale of any securities by the



graphs (a)(2) or (a)(3) but scienter is necessary in an aiding and abetting action.<sup>87</sup>

Although Section 17(a) is phrased similarly to Section 10(b) of the Exchange Act, considerable controversy exists concerning whether the courts will allow a private cause of action under Section 17(a).<sup>88</sup> Indeed, the Supreme Court has twice reserved decisions on whether Section 17(a) affords a private remedy.<sup>89</sup> Because much has been written about this issue, this article does not attempt to address this question. Most actions under Section 17(a) are also actionable under Section 10(b) of the Exchange Act and therefore most decisions under Section 17(a) rest on alternative theories.<sup>90</sup> Courts which allow a private action under Section 17(a) in all probability will also allow an action for aiding and abetting a violation of Section 17(a).<sup>91</sup>

---

use of any means or instruments of transportation or communication in interstate commerce or by the use of the mails, directly or indirectly

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

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

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

(b) It shall be unlawful for any person, by the use of any means or instruments of transportation or communication in interstate commerce or by the use of the mails, to publish, give publicity to, or circulate any notice, circular, advertisement, newspaper, article, letter, investment service, or communication which, though not purporting to offer a security for sale, describes such security for a consideration received or to be received, directly or indirectly, from an issuer, underwriter, or dealer, without fully disclosing the receipt, whether past or prospective, of such consideration and the amount thereof.

*Id.*

87. See *infra* notes 102-20 and 166-79 and accompanying text.

88. Compare *Landry v. All American Assurance Co.*, 688 F.2d 381 (5th Cir. 1982) (Section 17(a) of Securities Act affords no private cause of action) with *Berger v. Bishop Investment Corp.*, 695 F.2d 302 (8th Cir. 1982) (permitting private cause of action); *Stephenson v. Calpine Conifers II, Ltd.*, 652 F.2d 808 (9th Cir. 1981) (same); *Kirshner v. U.S.*, 603 F.2d 234 (2d Cir. 1978) (same). See also L. LOSS, *FUNDAMENTALS OF SECURITIES REGULATION* 1148-51 (arguing no private cause of action exists).

89. *Huddleston v. Herman & MacLean*, 459 U.S. 375, 378 n.2 (1983); *Teamsters v. Daniel*, 439 U.S. 551, 557 n.9 (1979).

90. The reason that the Supreme Court has been able to reserve decisions on the issue in the cases cited in note 89 *supra* is that most actions under Section 17(a) of the Securities Act are also actionable under Section 10(b) of the Exchange Act. Scienter is necessary, however, in an action under Section 10(b). *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 193 (1976).

91. See *SEC v. Coffey*, 493 F.2d 304 (6th Cir. 1974); *Timetrust, Inc. v. SEC*, 142 F.2d 744 (9th Cir. 1944) (examples of injunctive proceedings for aiding and abetting under Section 17). As discussed herein, the doctrine of liability for aiding and abetting developed independently of any particular section of the securities acts. Given the language of Section 17, no distinction should be drawn between actions under Section 17 and actions under other similar antifraud sections of the securities acts.

c. *Section 10(b) of the Exchange Act*

Section 10(b) of the Exchange Act<sup>92</sup> and Rule 10b-5 promulgated thereunder<sup>93</sup> are the provisions under which the great majority of aiding and abetting liability cases arise.<sup>94</sup> Generally, Rule 10b-5 prohibits the use or employment, in connection with the purchase or sale of any security, of any manipulative or deceptive device or contrivance. Unlike Section 12 of the Securities Act which restricts damages to a rescissional measure, Section 10(b) allows recovery for fraud in connection with the purchase or sale of a security. The "in connection with" standard, although certainly not unlimited, allows for recovery from persons other than the actual seller.<sup>95</sup> The imposition of liability for aiding and abetting a Section 10(b) violation effectively expands the scope of the section even further. Notwithstanding this expansion of primary liability, courts also allow recovery from aiders and abettors.<sup>96</sup>

Courts now require scienter of the primary violator before imposing direct liability.<sup>97</sup> Assuming a plaintiff establishes a primary violation with the requisite scienter, the court may impose aiding and abetting liability if the plaintiff establishes the secondary defendant's knowledge of the under-

---

92. 15 U.S.C. § 78j(b) (1982).

93. 17 C.F.R. § 240.10b-5 (1975). Rule 10b-5 of the Exchange Act provides:

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

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

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

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

*Id.*

94. The broad language of Section 10(b) of the Exchange Act and Rule 10b-5 is conducive to litigation. Examples are *Cleary v. Perfectune, Inc.*, 700 F.2d 774 (1st Cir. 1983); *Harmsen v. Smith*, 693 F.2d 932 (9th Cir. 1982), *cert. denied*, 464 U.S. 822 (1983); *SEC v. Seaboard Corp.*, 677 F.2d 1301 (9th Cir. 1982); *Stokes v. Lokken*, 644 F.2d 779 (8th Cir. 1981); *Monsen v. Consolidated Dressed Beef Co.*, 579 F.2d 793 (3d Cir. 1978); *Woodward v. Metro Bank*, 522 F.2d 84 (5th Cir. 1975); *Gaimes, Hooper & Messer, Inc. v. Pierce*, 519 F.2d 108 (9th Cir. 1975); *Brennan v. Midwestern United Life Ins., Co.*, 259 F. Supp. 673 (N.D. Ind. 1966), *aff'd*, 417 F.2d 147 (7th Cir. 1969), *cert. denied*, 397 U.S. 989 (1970). *See also infra* note 180-88 and accompanying text.

95. The fraud committed must be "in connection with" the purchase or sale of a security. *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723 (1975); *Birnbaum v. Newport Steel Corp.*, 193 F.2d 461 (2d Cir. 1952).

96. *Harmsen v. Smith*, 693 F.2d 932, 944 (9th Cir. 1982), *cert. denied*, 464 U.S. 822 (1983).

97. *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976). In *Hochfelder*, the Supreme Court dismissed an action against an accounting firm for allegedly aiding and abetting the fraud of an employee of a brokerage firm by negligently failing to discover the fraud during the accountants' audit of the brokerage firm. The Court held that proof of scienter is a necessary element of a cause of action under Section 10(b) and Rule 10b-5 but reserved the issue whether reckless conduct satisfies the scienter requirement. Most courts now hold that recklessness is sufficient. *See, e.g.*, *IIT v. Cornfeld*, 619 F.2d 909, 927 (2d Cir. 1980).

lying violation and substantial and knowing assistance by the defendant in that underlying violation.<sup>98</sup>

The language of Section 10(b) is by far the broadest in scope of the sections imposing civil liability. That a private right of action exists under Rule 10b-5 is now without question.<sup>99</sup> Not surprisingly, this is the section under which most of the Supreme Court decisions arise and thus Section 10b-5 has been the basis for the recent Supreme Court cases restricting private suits.<sup>100</sup> Given this trend under Rule 10b-5, expansive cases involving aiding and abetting liability are unlikely.<sup>101</sup>

## 2. Knowledge

Once the plaintiff has established the underlying violation of the securities laws, the second element necessary to establish liability for aiding and abetting a securities violation is knowledge of the underlying securities violation.<sup>102</sup> The plaintiff must prove two distinct knowledge requirements. First, the defendant must have had some knowledge of the existence of the action or inaction constituting the primary securities violation.<sup>103</sup> Second, the defendant must have had some knowledge that his assistance would further that primary violation.<sup>104</sup> These requirements should entail separate proof but the courts often fail to distinguish between them.<sup>105</sup> The second requirement is directly related to the substantial assistance element.<sup>106</sup>

Courts have differed as to the threshold standard of knowledge of the

98. See *supra* text accompanying note 52; *infra* notes 102-20, 166-79 and accompanying text.

99. *Chiarella v. U.S.*, 445 U.S. 222 (1980); *Sante Fe Industries, Inc. v. Green*, 430 U.S. 462 (1977); *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976); *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723 (1975).

100. See *infra* notes 181-88 and accompanying text.

101. See, e.g., *State Teachers Retirement Board v. Fluor Corp.*, [1984 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 91,656 (S.D.N.Y. Aug. 23, 1984) (court refused to expand tippee liability).

102. *Harmsen v. Smith*, 693 F.2d 932, 943 (9th Cir. 1982), *cert. denied*, 464 U.S. 822 (1983); *Rolf v. Blyth, Eastman Dillon & Co.*, 570 F.2d 38, 47 (2d Cir. 1978), *cert. denied*, 439 U.S. 1039 (1978); *Woodward v. Metro Bank*, 522 F.2d 84, 94-97 (5th Cir. 1975).

103. *Stokes v. Lokken*, 644 F.2d 779, 782 (8th Cir. 1981); *IIT v. Cornfeld*, 619 F.2d 909 (1980); *Ruder, supra* note 5, at 630-38.

104. *Herm v. Stafford*, 663 F.2d 669, 684 (6th Cir. 1981); *SEC v. Coffey*, 493 F.2d 1304, 1316 (6th Cir. 1974), *cert. denied*, 420 U.S. 908 (1975); *Brennan v. Midwestern United Life Ins. Co.*, 417 F.2d 147, 154-55 (7th Cir. 1969); *Timetrust, Inc. v. Sec.*, 142 F.2d 744 (9th Cir. 1944); *Fischer v. Kletz*, 266 F. Supp. 180, 197 (S.D.N.Y. 1967); *Ruder, supra* note 5, at 630-38.

105. See, e.g., *Landy v. FDIC*, 486 F.2d 139, 163-64 (3d Cir. 1973), *cert. denied*, 416 U.S. 960 (1974). Generally there are three ways to establish scienter: 1) direct evidence by written or oral statements, 2) circumstantial evidence, and 3) evidence of reckless conduct. Note, *The Private Action Against a Securities Fraud Aider and Abettor: Silent and Inactive Conduct*, 29 VAND. L. REV. 1233 (1976), citing *Ruder, supra* note 5, and A. BROMBERG, *supra* note 82, at § 8.4.

106. See *infra* text accompanying notes 166-79.

primary violation.<sup>107</sup> At the very least, recklessness is required.<sup>108</sup> Most courts, however, require actual awareness of the underlying violation as opposed to a reckless failure to discover the underlying violation.<sup>109</sup> One of the most often-quoted standards for knowledge of the underlying violation is stated in *Securities and Exchange Commission v. Coffey*.<sup>110</sup> There the Sixth Circuit stated that the knowledge requirement is satisfied if the defendant had a "general awareness that his role is part of an overall activity that is improper."<sup>111</sup> Because the courts often intertwine their discussion of the two separate scienter requirements, it is difficult to determine the exact requisite standard for proof of knowledge of the underlying violation.<sup>112</sup> The Fifth Circuit has called this requirement the "crucial element" in ensuring that aiders and abettors do not become insurers of other parties to a transaction under a strict liability theory.<sup>113</sup>

In examining the knowledge requirement, courts look to the circumstances surrounding the transaction and the expectations of the parties involved.<sup>114</sup> For instance, if the transaction occurs in the ordinary course of business of the alleged aider and abettor, more complicity is required to satisfy the knowledge requirement.<sup>115</sup> Perhaps the most important factor in this regard is the presence of a fiduciary duty owed by the alleged aider and abettor to the investor.<sup>116</sup> If such a relationship is present, a lower threshold standard

---

107. *Id.*

108. *Harmen v. Smith*, 693 F.2d 932, 943 (9th Cir. 1982), *cert. denied*, 464 U.S. 822 (1983); *SEC v. Seaboard Corp.*, 677 F.2d 1301 (9th Cir. 1982); *Stokes v. Lokken*, 644 F.2d 779 (8th Cir. 1981); *Edwards & Hanly v. Wells Fargo Sec. Clearance Corp.*, 602 F.2d 478, 484 (2d Cir. 1979), *cert. denied*, 444 U.S. 1045 (1980); *Rolf v. Blyth, Eastman Dillon & Co.*, 570 F.2d 38 (2d Cir. 1978), *cert. denied*, 439 U.S. 1039 (1978); *Tucker v. Janota*, [1979 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,701, at 94,716 (N.D. Ill. 1978). *See Note, supra* note 105, at 1261.

109. *Harmen v. Smith*, 693 F.2d 932, 943 (9th Cir. 1982), *cert. denied*, 464 U.S. 822 (1983); *Edwards & Hanly v. Wells Fargo Sec. Clearance Corp.*, 602 F.2d 478, 484 (2d Cir. 1979) (recklessness is sufficient if the defendant breached a fiduciary duty), *cert. denied*, 444 U.S. 1045 (1980); *Odette v. Shearson, Hammill & Co.*, 394 F. Supp. 946, 960 (S.D.N.Y. 1975); *but see Stokes v. Lokken*, 644 F.2d 779, 783 (8th Cir. 1981) (gross recklessness is necessary); *Herm v. Stafford*, 663 F.2d 669, 684 (6th Cir. 1981) (recklessness is sufficient).

110. 493 F.2d 1304 (6th Cir. 1974).

111. *Id.* at 1316. The *Coffey* court stated that the defendant must have actual knowledge of and conscious intent to substantially assist the violation. *Id.*

112. *Compare SEC v. Coffey*, 493 F.2d 1304 (6th Cir. 1974) (standard is general awareness that aider and abettor's role is part of overall improper activity), *cert. denied*, 420 U.S. 908 (1975), *with Landy v. FDIC*, 486 F.2d 130 (3d Cir. 1973) (standard is knowledge of wrong's existence), *cert. denied*, 416 U.S. 950 (1974). *See Note, Aiding and Abetting Under Rule 10b-5—A Stock Exchange May Be Liable for Aiding and Abetting a Securities Fraud Solely on the Basis of its Failure to Act*, 29 VAND. L. REV. 880 (1976) (comparison of approaches taken by different circuits).

113. *Woodward v. Metro Bank*, 522 F.2d 84, 96 (5th Cir. 1975) (citing *Ruder, supra* note 5, at 630-31).

114. *See, e.g., Woodward v. Metro Bank*, 522 F.2d 84, 95 (5th Cir. 1975).

115. *Id.*

116. *Id.* at 95-96; *Decker v. Massey-Ferguson*, 681 F.2d 111 (2d Cir. 1982); *Edwards & Hanly v. Wells Fargo Sec. Clearance Corp.*, 602 F.2d 478, 484-85 (2d Cir. 1979), *cert. denied*,

of knowledge will suffice.<sup>117</sup> Nevertheless, following *Ernst & Ernst v. Hochfelder*,<sup>118</sup> at a minimum the courts will require recklessness.<sup>119</sup> Whether the defendant merely should have been aware of the underlying securities violation is no longer an issue. Depending upon the circumstances surrounding the transaction, the alleged aider and abettor must at least be reckless in failing to discover the primary violation. In most cases, the defendant must have a general awareness of his role in the improper activity.<sup>120</sup>

### 3. Knowing and Substantial Assistance

The basis of aiding and abetting liability is the requirement that the defendant must have knowingly and substantially assisted the commission of the primary violation.<sup>121</sup> This element is the crux of the aiding and abetting cause of action and the basis of the most discussion in the cases. The Second Circuit stated in *IIT v. Cornfeld*:

[M]ere bystanders, even if aware of the fraud, cannot be held liable for inaction since they do not, in Judge Hand's words, associate themselves with the venture or participate in it as something they wish to bring about.<sup>122</sup>

In *Landy v. FDIC*,<sup>123</sup> the Third Circuit listed four factors in examining substantial assistance: (1) the amount of assistance given by the defendant; (2) his presence or absence at the time of the tort; (3) his relation to the other person; and (4) his state of mind.<sup>124</sup> The court also borrowed heavily from Restatement of Torts, Section 436, which states:

---

444 U.S. 1045 (1980); *Rolf v. Blyth, Eastman Dillon & Co.*, 570 F.2d 38, 44-45 (2d Cir. 1978), *cert. denied*, 439 U.S. 1039 (1978); Note, *Liability for Aiding and Abetting Violations of Rule 10b-5: The Recklessness Standard in Civil Damage Actions*, 62 TEX. L. REV. 1087, 1109 (1984).

117. *Woodward v. Metro Bank*, 522 F.2d 84, 97 (5th Cir. 1975). See *infra* notes 155-64 and 166-79 and accompanying text.

118. 425 U.S. 185 (1976).

119. See *supra* note 97 (discussing *Hochfelder*).

120. *Id.*; *SEC v. Coffey*, 493 F.2d 1304, 1316 (6th Cir. 1974), *cert. denied*, 420 U.S. 908 (1975).

121. *Cleary v. Perfectune, Inc.*, 700 F.2d 774, 778-79 (1st Cir. 1983); *Monsen v. Consol. Dressed Beef Co.*, 579 F.2d 793, 800 (3d Cir. 1978); *Woodward v. Metro Bank*, 522 F.2d 84, 96-97 (5th Cir. 1975); *Pettit v. American Stock Exchange*, 217 F. Supp. 21, 28 (S.D.N.Y. 1963).

122. 619 F.2d 909, 927 (2d Cir. 1980). In *IIT v. Cornfeld*, an accounting firm, an underwriting firm and brokers were sued by the liquidators of an investment fund for allegedly aiding and abetting various securities violations. The Second Circuit refused to accept the plaintiffs' argument that the failure of the accounting firm to report various violations to the proper authorities rendered the accounting firm liable for aiding and abetting a violation of the securities laws.

123. 486 F.2d 139 (3d Cir. 1973), *cert. denied*, 416 U.S. 960 (1974).

124. *Id.* at 163. In *Landy*, the plaintiffs, who were shareholders of a bank, alleged that

If the encouragement or assistance is a substantial factor in causing the resulting tort, the one giving it is himself a tortfeasor and is responsible for the consequences of the other's acts.<sup>125</sup>

#### a. Substantial Assistance

The substantial assistance element has two components: 1) the defendant's substantial assistance toward the underlying violation by physical act or omission;<sup>126</sup> and 2) knowledge that this assistance aids in the commission of the underlying violation.<sup>127</sup> The assistance can either be some affirmative act taken by the defendant or inaction when the defendant should have acted.<sup>128</sup> The set of circumstances under which action or inaction is sufficient to constitute substantial assistance is a question of fact determined on a case by case basis.

#### i. Assistance by Affirmative Acts

The easiest cases for the courts to decide have been those in which the alleged aider and abettor took some affirmative step to aid the primary violator. Examples of acts which courts have determined are sufficient to satisfy the substantial assistance test include verification by an accountant of misleading financial statements in a prospectus,<sup>129</sup> encouragement by a

two brokers' purchases and sales of stock foreseeably permitted the bank's president to violate Rule 10b-5 by independently siphoning the bank's funds. The bank was thereby forced into receivership. Applying the four factors, the court found that (1) the processing of the purchase and sale orders constituted minor assistance; (2) the brokers were not present at the time of the president's fraud; (3) the brokers were not involved in the purchase or sale of certain critical stock and made no misrepresentations; and (4) the brokers did not possess the necessary state of mind.

125. RESTATEMENT (SECOND) OF TORTS § 436 (1977). See *supra* note 42 and accompanying text (text and discussion of § 876 of RESTATEMENT OF TORTS); *Odette v. Shearson, Hammill & Co.*, 394 F. Supp. 946, 960 (S.D.N.Y. 1975); *Brennan v. Midwestern United Life Ins. Co.*, 259 F. Supp. 673, 680 (N.D. Ind. 1966), *aff'd*, 417 F.2d 147 (7th Cir. 1969); *Ruder*, *supra* note 5, at 620.

126. *Cleary v. Perfectune, Inc.*, 700 F.2d 774, 778 (1st Cir. 1983); *IIT v. Cornfeld*, 619 F.2d 909, 925-28 (2d Cir. 1980); *Edwards & Hanly v. Wells Fargo Sec. Clearance Corp.*, 602 F.2d 478, 483 (2d Cir. 1979), *cert. denied*, 444 U.S. 1045 (1980).

127. *IIT v. Cornfeld*, 619 F.2d 909, 925-28 (2d Cir. 1980); *Monsen v. Consol. Dressed Beef Co.*, 579 F.2d 793, 800 (3d Cir. 1978); *Woodward v. Metro Bank of Dallas*, 552 F.2d 84, 96-97 (5th Cir. 1975). The dual nature of the substantial assistance element of aiding and abetting liability originated in criminal law. See *Ruder*, *supra* note 5.

128. *Compare Carroll v. First Nat'l Bank*, 413 F.2d 353 (7th Cir. 1969), *cert. denied*, 396 U.S. 1003 (1970), with *Brennan v. Midwestern United Life Ins. Co.*, 417 F.2d 147 (7th Cir. 1969). In order to impose aiding and abetting liability, courts generally require the defendant to have had more knowledge of his or her assistance in the violation of the securities laws where the assistance arose from the defendant's failure to act than where the defendant's assistance was active. See *infra* notes 167-79 and accompanying text.

129. *SEC v. Seaboard Corp.*, 677 F.2d 1301 (9th Cir. 1982) (SEC proceeding). In *Seaboard*,

bank of a company's issuance of unregistered subordinated debt accompanied by the ability of the bank to terminate the issuance,<sup>130</sup> creation of a credit bubble<sup>131</sup> to conceal various speculative purchases in violation of Section 10(b) of the Exchange Act,<sup>132</sup> supplying false information to a securities firm and falsifying the bank's records to conceal debt,<sup>133</sup> and loaning money to investors to facilitate the sale of unregistered securities.<sup>134</sup> The courts have drawn a flexible line in determining whether a specific affirmative act is sufficient to satisfy the substantial assistance requirement.<sup>135</sup> This is a factual question that will be determined on the basis of all of the circumstances surrounding the transaction or series of transactions in question.<sup>136</sup>

## ii. Assistance by Inaction

More troublesome to the courts are the cases in which the defendant is alleged to have failed to act when he should have acted.<sup>137</sup> Although the courts vary considerably in their approaches to this area, several consistent trends are present.

As a general rule, absent the presence of a special circumstance discussed

the court specifically noted that it was not deciding whether aiding and abetting liability exists under the securities laws. *Id.*

130. *Monsen v. Consol. Dressed Beef Co.*, 579 F.2d 793 (3d Cir. 1978). See *infra* text accompanying notes 152-55 and 230-33.

131. A credit bubble can arise in a number of situations. In one case, *Carroll v. First National Bank*, 413 F.2d 353 (7th Cir. 1969), *cert. denied*, 396 U.S. 1003 (1970), a bank made large purchases of securities. Although the sellers of the securities required cash against delivery, the bank allegedly delayed payment for as long as possible in the hope of a rising market.

132. *Carroll v. First Nat'l Bank*, 413 F.2d 353 (7th Cir. 1969), *cert. denied*, 396 U.S. 1003 (1970). See *infra* text accompanying notes 249-53.

133. *Odette v. Shearson, Hammill & Co.*, 394 F. Supp. 946 (S.D.N.Y. 1975). See *infra* text accompanying notes 209-13.

134. *Tucker v. Janota*, [1979 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,701 (N.D. Ill. 1978). See *infra* text accompanying notes 155-56.

135. Compare *Rolf v. Blyth, Eastman Dillon & Co.*, 570 F.2d 38 (2d Cir. 1978), *cert. denied*, 439 U.S. 1039 (1978), with *H. L. Federman & Co. v. Greenberg*, 405 F. Supp. 1332 (S.D.N.Y. 1975). See also 2 A. BROMBERG, *supra* note 82, at § 8.5 (substantial assistance may include "repeating misrepresentations (or aiding in their preparation), . . . by acting as conduits to accumulate or distribute securities, . . . executing transactions or investing proceeds, or perhaps . . . financing transactions").

136. *Woodward v. Metro Bank*, 522 F.2d 84 (5th Cir. 1975). In *Woodward*, the Fifth Circuit stated "Substantiality is a function of all of the circumstances." *Id.* at 97.

137. Some cases involving allegations of aiding and abetting through inaction arise through the defendant's alleged failure to disclose some material point when he had a fiduciary duty to do so. See, e.g., *In re Flight Trans. Corp. Sec. Litig.*, [1984 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 91,622 (D. Minn. July 5, 1984). Other cases of alleged aiding and abetting through inaction result from the failure of the defendant to discover certain material matters. See, e.g., *Edwards & Hanly v. Wells Fargo Sec. Clearance Corp.*, 602 F.2d 478 (2d Cir. 1979), *cert. denied*, 444 U.S. 1045 (1980). Still other cases arise from the defendant's alleged failure to report the violator to the authorities. See, e.g., *Brennan v. Midwestern United Life Ins. Co.*, 417 F.2d 147 (7th Cir. 1969).

below, no aiding and abetting liability exists for inaction alone.<sup>138</sup> This is true for at least three reasons. First, Restatements of Torts, Section 876, one of the sources from which the aiding and abetting cause of action developed, encompasses only the cause of physical harm and does not address economic loss.<sup>139</sup> At the time Section 876 was proposed, this section extended liability to secondary defendants whose failure to act caused physical harm to another.<sup>140</sup> Further extending liability to secondary defendants for economic loss is a step the courts seem unwilling to take unless certain special circumstances discussed below warrant such an extension.<sup>141</sup>

Second, the securities acts do not specifically address aiding and abetting liability. Furthermore, the inclusion of the sections imposing liability on controlling persons indicates a limitation of liability for secondary defendants.<sup>142</sup> As discussed earlier, many of the sections on which the underlying violations are based do not even specifically grant a private cause of action and the courts have had to grant private rights of action judicially.<sup>143</sup> Further imposing aiding and abetting liability on the basis of inaction alone expands liability beyond what some courts view as the scope of the securities acts.<sup>144</sup>

Third, courts have declined to impose aiding and abetting liability under the securities law for failure to act because the alleged conduct is the subject of other federal or state laws that preempt liability under the securities laws. As the Fifth Circuit stated in *Woodward v. Metro Bank*:

The court must ask whether the conduct in the case before it was the type of behavior meant to be forbidden by the securities acts, remembering that business transactions are not all reducible to a purchase or sale of a security. Many areas of business activity are governed by state laws, such as the Uniform Commercial Code, or other federal laws, such as the Truth-in-Lending Act, 15 U.S.C. § 1601 et seq. (1970), and the antitrust laws. Some transactions, it is only logical to assume, should be left to the operation of these other

---

138. *IIT v. Cornfeld*, 619 F.2d 909, 925-26 (2d Cir. 1980) (citing *Wessel v. Buhler*, 437 F.2d 279 (9th Cir. 1971); *Ruder*, *supra* note 5. See *infra* text accompanying notes 148-65 (discussing circumstances in which courts impose liability for aiding and abetting where defendant has failed to act). Some courts allow aiding and abetting actions based solely on inaction if the silence or inaction was consciously intended to aid the underlying violation. *IIT v. Cornfeld*, 619 F.2d 909 (2d Cir. 1980); *SEC v. Coffey*, 493 F.2d 1304 (6th Cir. 1974), *cert. denied*, 420 U.S. 908 (1975); *Wessel v. Buhler*, 437 F.2d 279 (9th Cir. 1971).

139. RESTATEMENT (SECOND) OF TORTS § 876 (1977). See *supra* note 42 (text of Section 876); *supra* note 125 (cases citing Section 876).

140. See RESTATEMENT (SECOND) OF TORTS § 876 (1977) (illustrating effect of Section 876).

141. See *infra* text accompanying notes 148-66 (discussion of special circumstances in which courts impose aiding and abetting liability for inaction).

142. See *supra* notes 12-18 and accompanying text.

143. See *supra* notes 27-35 and accompanying text.

144. *IIT v. Cornfeld*, 619 F.2d 909 (2d Cir. 1980); *Wessel v. Buhler*, 437 F.2d 279 (9th Cir. 1971).



laws, for Rule 10b-5 was not designed to be the ethical Ten Commandments for all securities transactions.<sup>145</sup>

Although the Supreme Court has held that remedies under different provisions of the Securities Act are cumulative,<sup>146</sup> courts have preferred to require actions under other federal or state laws when the acts in question clearly fall within the prohibitions of one of those acts and only questionably fall within the prohibitions of the securities acts.<sup>147</sup>

As an exception to the general rule, several sets of special circumstances exist under which the courts will impose liability in failure to act cases. These include profit to the alleged aider and abettor by his failure to act,<sup>148</sup> the ability of the alleged aider and abettor to discover material inside information,<sup>149</sup> the relationship of the defendant to the other parties,<sup>150</sup> and the presence of a fiduciary duty by the alleged aider and abettor to another party in the transaction.<sup>151</sup>

Two cases exemplify the application of the special circumstances exception. In *Monsen v. Consolidated Dressed Beef Co., Inc.*,<sup>152</sup> the plaintiff alleged that the defendant bank aided and abetted a corporation's issuance of its unregistered promissory notes pursuant to an optional employee payroll deduction plan. In loaning money to the corporation, the bank required that the promissory notes be subordinated to the bank's loans, which the corporation agreed to do. The employees did not know of the subordination nor of the violation of the securities acts by the corporation's failure to register the payroll deduction plan. Although the bank should have known of the plan's illegality, the bank encouraged the corporation to continue the note program. In imposing aiding and abetting liability against the bank, the court of appeals gave considerable weight to the bank's improved position through the continuation of the note program.<sup>153</sup> Although this case involved a combination of the secondary defendant's affirmative act (the bank's encouragement to continue the note program) with the primary violators' failure

---

145. 522 F.2d 84, 90-91 (5th Cir. 1975) (footnote omitted).

146. *Herman & MacLean v. Huddleston*, 459 U.S. 375 (1983).

147. *See, e.g., Woodward v. Metro Bank*, 522 F.2d 84 (5th Cir. 1974).

148. *See Monsen v. Consol. Dressed Beef Co.*, 579 F.2d 793 (3d Cir. 1978); *Gould v. American-Hawaiian S.S. Co.*, 535 F.2d 761, 780 (3d Cir. 1976); *infra* text accompanying notes 152-55 and 230-33 (discussing *Monsen*).

149. *See Tucker v. Janota*, [1979 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,701, at 97,716 (N.D. Ill. 1978); *infra* text accompanying notes 155-56.

150. *See, e.g., Rolf v. Blyth, Eastman Dillon & Co.*, 570 F.2d 38, 47-48 (2d Cir.) (suit against registered representative for allegedly aiding and abetting investment advisor's violations), *cert. denied*, 439 U.S. 1039 (1978); *see also infra* text accompanying notes 157-65.

151. *See Woodward v. Metro Bank*, 522 F.2d 84, 95-96 (5th Cir. 1975); *Brennan v. Midwestern United Life Ins. Co.*, 417 F.2d 147 (7th Cir. 1969); *In re Flight Transp. Corp. Sec. Litig.*, [1984 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 91,622 (D. Minn. July 5, 1984).

152. 575 F.2d 793 (3d Cir. 1978).

153. *Id.* at 802.

to act (the company's failure to disclose to the employees the subordinated status of the debt), the plaintiffs' loss was primarily due to the company's failure to disclose. In imposing liability, the court acknowledged that the bank had no duty of disclosure to the employees and stressed that, while the bank had the authority to require the corporation to discontinue the program, the bank instead encouraged the continuation of the program to its own profit.<sup>154</sup>

In *Tucker v. Janota*,<sup>155</sup> the district court examined aiding and abetting liability in the context of a defendant's failure to discover material inside information. In *Tucker*, certain banks had a standing arrangement with an investment firm pursuant to which the investment firm referred potential investors to one of the banks for loans. The proceeds of these loans were used to make various investments in tax shelters and limited partnerships. The investment firm was not qualified to design the shelters and the securities were not properly registered. The investors lost their money and turned to one of the banks for recovery. The court held the bank liable on an aiding and abetting theory. The court first determined that the bank owed no duty of inquiry regarding the securities to the investors but found, however, that the bank consciously and substantially assisted the fraudulent scheme.<sup>156</sup> In imposing liability on the bank, the court coupled the affirmative act of the defendant in loaning money to the investors with the bank's failure to determine that the securities were not registered and that the investment firm was not qualified to design the tax shelters. It is important to note in this respect that the plaintiffs lost money as a result of the bank's failure to discover and disclose the problems surrounding the investment firm and not as a result of the bank's loans. The court properly should have treated the events as a case of the bank's failure to act.

The bulk of the special exception inaction cases, however, arise in the situation where the alleged aider and abettor owes a fiduciary duty to the investor.<sup>157</sup> In these cases, the courts generally allow an aiding and abetting cause of action based on inaction alone.<sup>158</sup> One example of this situation is *Brennan v. Midwestern United Life Insurance Company*.<sup>159</sup> In *Brennan*, a

---

154. *Id.* at 803, n.17-18.

155. [1979 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,701 (N.D. Ill. Nov. 1, 1978).

156. *Id.* at 94,716. In *Tucker*, in order to hold the defendant liable for inaction, the court required the plaintiff to prove the defendant's conscious intent to aid and abet the securities violation. See *infra* text accompanying notes 167-79.

157. See *Rolf v. Blyth, Eastman Dillon & Co.*, 570 F.2d 38 (2d Cir. 1978), *cert. denied*, 439 U.S. 1039 (1978); *Woodward v. Metro Bank*, 522 F.2d 84 (5th Cir. 1975); *Brennan v. Midwestern United Life Ins. Co.*, 417 F.2d 147 (7th Cir. 1969); *In re Flight Transp. Corp. Sec. Litig.*, [1984 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 91,622 (D. Minn. 1984); *Rosen v. Dick*, [1974-1975 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 94,786 (S.D.N.Y. 1974). The Supreme Court has defined duty as "aris[ing] from the relationship between the parties . . . and not merely from one's ability to acquire information because of his position in the market." *Chiarella v. U.S.*, 445 U.S. 185 (1980).

158. The courts generally require conscious intent in these circumstances. See *infra* notes 167-79 and accompanying text.

159. 417 F.2d 147 (7th Cir. 1969).

corporation whose securities were being traded through a particular broker-dealer advised persons complaining of certain of the broker-dealer's actions to try to resolve the problems directly with the broker-dealer and, if still unsatisfied, to report him to the Indiana Securities Commission or the SEC. The broker-dealer's manipulative actions in selling short and maintaining a market in these securities increased their value. The district court held that the corporation aided and abetted the broker-dealer's violations of Rule 10b-5 by advising complainants to deal directly with the broker-dealer and by failing to report him to the Indiana Securities Commission or the SEC after threatening to do so.<sup>160</sup> The Seventh Circuit affirmed the district court's decision.<sup>161</sup> By advising persons to contact the broker-dealer directly, the corporation alerted the broker-dealer to potential problems that could be rectified without interference from the regulators. The court found that this behavior violated the corporation's fiduciary duty to its shareholders. The court did not state whether the failure to disclose the matter to the authorities absent the statements to the complainants was sufficient to establish liability.<sup>162</sup> This case has been cited to support the argument that silence and inaction alone is a basis for aiding and abetting liability.<sup>163</sup> *Brennan* also has been cited to support the argument that silence and inaction must be combined with some affirmative act before the substantial assistance criterion is met.<sup>164</sup> The court stressed in *Brennan*, however, that the combination of the silent acquiescence and the affirmative referrals to the broker-dealer was the basis for imposition of liability.<sup>165</sup>

*b. Knowledge of Assistance*

As discussed earlier, the defendant must know that his actions will substantially assist the underlying violation. In cases where the defendant rendered assistance by affirmative act, knowledge is proven through the presumption that one is aware of the natural and logical consequences of his acts.<sup>166</sup> In cases where the defendant rendered assistance by silence or inaction, however, proof of knowing assistance is more difficult.

What proof of knowledge is necessary in inaction cases often revolves around the presence or absence of a fiduciary duty, particularly a duty of disclosure.<sup>167</sup> As the Fifth Circuit stated in *Woodward v. Metro Bank*:

---

160. 286 F. Supp. 702 (N.D. Ind. 1966).

161. 417 F.2d at 155.

162. *Id.* at 154.

163. *Woodward v. Metro Bank*, 522 F.2d 84, 96 (5th Cir. 1975).

164. *Landy v. FDIC*, 486 F.2d 139, 161 (3d Cir. 1973), *cert. denied*, 416 U.S. 950 (1974).

165. 417 F.2d at 154.

166. W. PROSSER & W. KEETON, *THE LAW OF TORTS* § 41 (5th ed. 1984).

167. *See, e.g.*, *IIT v. Cornfeld*, 619 F.2d 909 (2d Cir. 1980); *Brennan v. Midwestern United Life Ins. Co.*, 417 F.2d 147 (7th Cir. 1969).

When it is impossible to find any duty of disclosure, an alleged aider-abettor should be found liable only if scienter of the higher "conscious intent" variety can be proved. Where some special duty of disclosure exists, then liability should be possible with a lesser degree of scienter. . . . In a case combining silence/inaction with affirmative assistance, the degree of knowledge required should depend on how ordinary the assisting activity is in the business involved.<sup>168</sup>

In a situation involving inaction where the alleged aider and abettor owes a fiduciary duty to the injured party, less scienter need be shown.<sup>169</sup> In contrast, if the alleged aider and abettor owes no duty in the transaction, "conscious intent" is necessary.<sup>170</sup> Furthermore, in such cases courts generally require proof of the requisite intent by direct evidence rather than by inference.<sup>171</sup> When the aider and abettor owes no fiduciary duty, courts view the defendant as more remote and state that the requisite degree of scienter scales upward as the parties become more remote.<sup>172</sup> "Remoteness" tends to turn on the presence or absence of a special duty<sup>173</sup> although some courts view remoteness as a function of causation.<sup>174</sup>

A higher degree of scienter is required where the assisting activity is a routine part of business.<sup>175</sup> If the assisting activity is outside of normal business practices or lacks business justification, the courts require a lesser showing of scienter.<sup>176</sup> In practice, however, scienter is inferred by circum-

---

168. 522 F.2d 84, 97 (5th Cir. 1975) (footnotes omitted).

169. The courts impose a recklessness standard when the alleged aider and abettor owed a fiduciary duty to the plaintiff. *Cleary v. Perfectune, Inc.*, 700 F.2d 774 (1st Cir. 1983); *Decker v. Massey-Ferguson, Ltd.*, 681 F.2d 111 (2d Cir. 1982); *Rolf v. Blyth, Eastman Dillon & Co.*, 570 F.2d 38 (2d Cir. 1978), *cert. denied*, 439 U.S. 1039 (1978); *Woodward v. Metro Bank*, 522 F.2d 84 (5th Cir. 1974); *Brennan v. Midwestern United Life Ins. Co.*, 417 F.2d 147 (7th Cir. 1969), *cert. denied*, 397 U.S. 989 (1970).

170. *IIT v. Cornfeld*, 619 F.2d 909, 925 (2d Cir. 1980); *Woodward v. Metro Bank*, 522 F.2d 84, 97 (5th Cir. 1974); *SEC v. Coffey*, 493 F.2d 1034 (6th Cir. 1974), *cert. denied*, 420 U.S. 908 (1975); *Wessel v. Buhler*, 437 F.2d 279 (9th Cir. 1971); *Rosen v. Dick*, [1974-1975 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 94,786 (S.D.N.Y. 1974).

171. See note, *supra* note 105.

172. *Woodward v. Metro Bank*, 522 F.2d 84 (5th Cir. 1974).

173. See, e.g., *id.* at 97.

174. See, e.g., *Landy v. FDIC*, 486 F.2d 139 (3d Cir. 1973), *cert. denied*, 416 U.S. 960 (1974). The argument is that if the defendant's actions are considered too "remote," the actions did not "cause" the plaintiff's loss.

175. *Woodward v. Metro Bank of Dallas*, 522 F.2d 84 (5th Cir. 1974); *Ruder*, *supra* note 5, at 633. See Note, *supra* note 105.

176. *Woodward v. Metro Bank*, 522 F.2d 84 (5th Cir. 1974); *Brennen v. Midwestern United Life Ins. Co.*, 417 F.2d 147 (7th Cir. 1969), *cert. denied*, 397 U.S. 989 (1970); *Ruder*, *supra* note 5; Note, *supra* note 105.

stantial evidence when the abetting activity is not a routine part of business. Thus, courts only require less proof by direct evidence.<sup>177</sup> For example, in *Long v. McAlpin*,<sup>178</sup> a bank acted as a depository for cash received by an investment fund. The bank waived its normal handling fee and had no power to pass on the merit or frequency of investments. The court of appeals imposed no liability for aiding and abetting the investment manager's churning of accounts. The waiver of the usual handling fee by the depository negated any inference of assistance for pecuniary gain. In the same case, two other banks served as custodians. One bank acted solely at the direction of the trustee and no proof was offered against the other bank for alleged transfers of funds to inappropriate parties. Again, the Second Circuit refused to impose liability.<sup>179</sup> First, the banks' actions were not the cause of the plaintiffs' losses and second, the banks acted in the normal course of business and lacked scienter.

By establishing a sliding scale for determining the presence of scienter, the courts can be flexible in imposing aiding and abetting liability. The sliding scale does not provide much guidance, however, to parties trying to determine in advance the permissible parameters of behavior in specific transactions. The courts must be consistent in their approaches to aiding and abetting cases to achieve in the marketplace a more efficient use of resources, knowledge of permissible behavioral parameters and the allocation of potential risks among the parties involved.

### C. Recent Supreme Court Decisions

In a trend affecting not only aiding and abetting liability but also primary liability and secondary liability, the Supreme Court has restricted the scope of the coverage of the securities acts through a series of fairly recent decisions. Most notably, the Court begins with the language of the specific statute.<sup>180</sup> The Court has rejected the imposition of liability based solely on the broad policies behind the securities acts.<sup>181</sup> For example, the Court upheld the so-called *Birnbaum* rule in *Blue Chip Stamps v. Manor Drug Stores*<sup>182</sup> which requires that a plaintiff in a Section 10(b) case be a purchaser or seller of a security to satisfy the "in connection with" requirement of Section 10(b).<sup>183</sup>

---

177. See *Long v. McAlpin*, 699 F.2d 79 (2d Cir. 1983). See generally Ruder, *supra* note 3; Note, *supra* note 105.

178. 699 F.2d 79 (2d Cir. 1983).

179. *Id.* The court dismissed because of the plaintiff's failure to plead the defendant's alleged fraud with particularity. The defendant's actions were within standard business practices.

180. See *Herman & MacLean v. Huddleston*, 459 U.S. 375 (1983); *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976); *Sante Fe Industries, Inc. v. Green*, 430 U.S. 462 (1977); *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723 (1975).

181. See *supra* note 180.

182. 421 U.S. 723 (1975).

183. *Id.* at 754-55. In *Birnbaum v. Newport Steel Corp.*, 193 F.2d 461 (2d Cir. 1952), the court held that because the language of § 10(b) of the Exchange Act and Rule 10b-5 proscribed only fraud in connection with the purchase or sale of securities, only actual purchasers and

In *Sante Fe Industries, Inc. v. Green*,<sup>184</sup> the Court refused to find that a breach of fiduciary duty involving oppressive conduct actionable under state corporate law amounted to a manipulative or deceptive device or contrivance under Rule 10b-5.<sup>185</sup> In *Ernst & Ernst v. Hochfelder*,<sup>186</sup> the Court examined the language and legislative history of Section 10(b) and concluded that negligence alone is insufficient to impose liability, and that scienter is necessary. In addition, the Court recently clarified and restricted tippee liability in *Chiarella v. United States*<sup>187</sup> and *Dirks v. SEC*.<sup>188</sup>

The Ninth Circuit questioned the availability of an aiding and abetting cause of action under Section 10(b) of the Securities Act in light of these cases, in a footnote in *SEC v. Seaboard Corp.*<sup>189</sup> The parties assumed potential aiding and abetting liability; therefore, the Ninth Circuit considered the case on that basis, and expressly declined to confront the underlying issue. The Ninth Circuit cited the Supreme Court's prescription for a strict construction of the securities laws rather than a mere reliance on the broad policy objectives of the securities acts. The *Seaboard* court also restated Professor Fischel's arguments that *Ernst & Ernst v. Hochfelder* implicitly held that aiding and abetting liability does not exist as a separate offense and that the Supreme Court, if confronted with the question, probably would not recognize secondary liability theories.<sup>190</sup>

The same circuit, however, reversed its position in *Harmsen v. Smith*.<sup>191</sup> The court of appeals stated that the Supreme Court had not yet followed the suggestion made in the footnote in *Seaboard* and that other circuits still impose liability for aiding and abetting a securities law violation.<sup>192</sup> Given

---

sellers can maintain Rule 10b-5 actions. 193 F.2d at 463-64. In *Blue Chip Stamps*, the Court adopted both the reasoning and the conclusion of *Birnbaum*.

184. 430 U.S. 462 (1977).

185. *Id.* The Court ruled that Rule 10b-5 and Section 10b of the Exchange Act specifically addressed manipulative and deceptive practices, and that these provisions did not extend to a breach of fiduciary duty that did not involve deception or manipulation. *Id.* at 492-96.

186. 425 U.S. 185 (1976).

187. 445 U.S. 222 (1980). In *Chiarella*, a printing company employee obtained material nonpublic information regarding companies that were about to merge or be taken over, purchased stock in those companies before the takeovers were public information and then sold the stock at a profit. The Court held that he could not be convicted of fraud under Section 10(b) because he had no duty to disclose that information to the sellers absent some relationship with the sellers that would give rise to a duty to disclose.

188. 463 U.S. 646 (1983). In *Dirks*, the Court reversed the decision of the court of appeals in upholding an SEC censure of a securities analyst. The analyst had discovered fraud in a corporation he analyzed and had passed that information to clients, who immediately sold the corporation's stock. The Court held that the analyst should not be censured merely because his position in the market as a securities analyst gave him access through legitimate means to certain nonpublic inside information. The Court reaffirmed its holding in *Chiarella* that the analyst had no duty to disclose where he was not an agent or fiduciary of the corporation, nor a person in whom the sellers of the securities had placed their trust and confidence. *Id.* at 922.

189. 677 F.2d 1301, 1311 n.12 (9th Cir. 1982).

190. *Id.* (citing Fischel, *supra* note 17).

191. 693 F.2d 932 (9th Cir. 1982).

192. *Id.* at 944.

this retreat by the only court to reexamine the issue following the recent restrictive decisions by the Supreme Court, lower courts are unlikely to follow *Seaboard's* suggestion unless the Supreme Court gives some new reason to do so.

### III. POTENTIAL LIABILITY OF FINANCIAL INSTITUTIONS

#### A. *Transactions which Foster Potential Aiding and Abetting Liability*

Financial institutions enter into myriad transactions that present potential liability for aiding and abetting a securities violation. Given the recent proliferation of banking services, this potential liability becomes even more apparent.<sup>193</sup> Five specific types of transactions which foster aiding and abetting liability will be discussed: 1) loans;<sup>194</sup> 2) credit enhancement;<sup>195</sup> 3) dissemination of information;<sup>196</sup> 4) actions taken by banks acting in a fiduciary relationship;<sup>197</sup> and 5) direct aid of a conscious scheme to defraud.<sup>198</sup>

##### 1. Loans

The standard loan transaction is the most common transaction that may give rise to aiding and abetting liability. Obviously a loan may be structured in a variety of ways. Although each may present its own problems, the general problems created by the various structures are very similar.<sup>199</sup> Direct loans, letters of credit and construction loans constitute only a few of the various possible loan structures.<sup>200</sup> Each case discussed below in which liability was imposed involved a separate security sufficient to satisfy the underlying securities violation requirement.

---

193. The Glass-Steagall Act, Ch. 89, 48. Stat. 162 (codified as amended in scattered sections of 12 U.S.C.), prohibits banks from engaging in most investment banking and securities activities. As summarized in Comment, *Regulation of Bank Securities Activities*, 41 WASH. & LEE L. REV. 1187 (1984), and Note, *National Banks and the Brokerage Business: The Comptroller's New Reading of the Glass-Steagall Act*, 69 VA. L. REV. 1303 (1983), the distinction between commercial and investment banking is blurring. As banks become increasingly involved in investment banking activities, they must also remain aware of the securities laws ramifications.

194. See *infra* notes 199-218 and accompanying text.

195. See *infra* notes 219-37 and accompanying text. Techniques of credit enhancement are similar to standard loan transactions except that considerations also arise regarding the underlying security which is the recipient of the credit enhancement.

196. See *infra* text accompanying notes 238-43.

197. See *infra* notes 244-48 and accompanying text.

198. See *infra* text accompanying notes 249-53.

199. Banks generate income through the making of loans and the collection of fees from services rendered. Many of the different transactions banks enter entail some form of the standard loan, whether it is a residential mortgage loan, revolving term loan, letter of credit issuance or an agreement to purchase securities in the future.

200. See Annot., 39 A.L.R. FED. 357 (1978) (discussion of whether promissory note constitutes a security); see also *Zabriskie v. Lewis*, 507 F.2d 546 (10th Cir. 1974); Comment,

In each loan transaction, the financial institution should be aware of both the intended use and the actual use of the proceeds of the loan. In addition to the bank's concern as to the ability of the debtor to repay the loan, the bank should be aware of the use of the proceeds for federal securities purposes.<sup>201</sup> If the proceeds of the loan are used to commit, or are the product of, a securities law violation, the bank faces a potential lawsuit for aiding and abetting that violation.<sup>202</sup>

For example, in *Edwards & Hanly v. Wells Fargo Securities Clearance Corp.*,<sup>203</sup> a bank loaned money to a broker ostensibly trading securities on matched sales. The broker, however, began selling the securities short for his own account in violation of Regulation T<sup>204</sup> and lost money in a rising market. The bank only later became aware of the fact that the sales were short. The plaintiff, a securities firm, then turned to the bank for recovery on an aiding and abetting theory. The federal district court held for the plaintiff<sup>205</sup> but the Second Circuit reversed on the question of causation.<sup>206</sup>

The Second Circuit rejected the plaintiff's argument that "but for" causation is sufficient to establish the requisite knowing and substantial assistance element.<sup>207</sup> The plaintiff lost money not because of the bank's loan to the broker but because the broker did not inform the plaintiff that the sales were not matched sales. Only if the bank's employee had a duty to disclose his knowledge of the short sales would the court impose liability. The plaintiff, however, failed to use due diligence to discover that the broker's sales were short. Consistent late deliveries of the stock should have put the plaintiff on notice that the sales were short, the plaintiff should have inquired whether the sales were short, and if so, the plaintiff should have "bought in" within a reasonable time.<sup>208</sup> Therefore the Second Circuit deemed recovery against the bank inappropriate.

---

*Notes as Securities under the Securities Act of 1933 and the Securities Exchange Act of 1934*, 36 MD. L. REV. 233 (1976). Because aiding and abetting liability requires an underlying securities violation, whether a standard promissory note constitutes a "security" triggering the jurisdiction of the federal securities laws is a question of direct liability which is not within the scope of this article.

201. Through most banks' loan application and approval processes, the bank will be aware of the intended use of loan proceeds. Unless the bank institutes some control over the actual use of the proceeds in the loan documents, however, the bank will have no assurance that the proceeds will be spent in accordance with the bank's expectations.

202. See *supra* text accompanying notes 102-20 and 166-79 (before bank will be held liable, bank must have some actual or imputed knowledge of the securities laws violations).

203. 602 F.2d 478 (2d Cir. 1979), *cert. denied*, 444 U.S. 1045 (1980).

204. Regulation T, promulgated under the Exchange Act by the Board of Governors of the Federal Reserve System, relates to the method by which purchases or sales of securities by broker firms may be made. 12 C.F.R. § 220.4 (1985).

205. 458 F. Supp. 1110 (S.D.N.Y. 1978).

206. 602 F.2d at 489.

207. *Id.* at 484-89.

208. "Buying in" refers to the purchase of stock for the purpose of returning stock previously borrowed to make delivery on a short sale.



*Edwards & Hanly* must be read cautiously. Although the bank was not held liable in this case, the case is an example of a bank's failure to discover its customer's actual use of loan proceeds. The bank originally believed that it was only loaning funds to the broker for use while the purchaser's funds cleared but this was not true. Had the bank been more involved in the broker's activities and thus either known, or had reason to know, of the broker's violations, the result might have been different. *Edwards & Hanly* turned on a factual question of causation and did not hold that a plaintiff cannot prevail on a theory of aiding and abetting against a bank that knows or should know of the principal defendant's violation of securities laws.

In *Odette v. Shearson, Hammill & Co.*,<sup>209</sup> the federal district court denied a motion by the third-party defendant to dismiss for failure to state a cause of action where the plaintiff had alleged a sale of a corporation's securities by the defendant while the defendant possessed materially adverse inside information about the corporation. The principal defendants sought indemnification and contribution against a bank for aiding and abetting, and conspiring with, the corporation's officers who gave false information to the principal defendant. The bank allegedly made long-term loans to the corporation in excess of the bank's legal lending limit and in exchange for bribes. The bank also allegedly falsified its books to make the loans appear as if made to a third party to conceal the violation of the lending limit and to assist the corporation in concealing some of its debt.<sup>210</sup> The corporation also allegedly falsified its own books to further conceal the debt.

The *Odette* court refused to allow the indemnification action.<sup>211</sup> The court, however, permitted the principal defendant to proceed with the contribution action for aiding and abetting. The principal defendant's ability to recover turned on the bank's substantial assistance.<sup>212</sup> The court found substantial assistance even though the bank made no direct misrepresentations to those who were ultimately deceived. The bank's cooperation in the falsification of the corporation's books was necessary for the overall scheme to succeed and constituted sufficient substantial assistance for the imposition of liability.<sup>213</sup>

In *Tucker v. Janota*<sup>214</sup> discussed above, two banks allegedly made loans to customers of an investment firm to provide the customers with sufficient funds to invest in certain tax shelters. The banks were aware that the

---

209. 394 F. Supp. 946 (S.D.N.Y. 1975), on remand from 517 F.2d 398 (2d Cir. 1974).

210. *Id.* at 953.

211. *Id.* at 954-55. The plaintiff would have to prove the principal defendant's knowledge or recklessness in committing the violations. The principal defendant's scienter precludes an action against a third-party defendant for indemnification. See Fischer, *Contribution in 10b-5 Actions*, 33 BUS. LAW. 1821 (1978).

212. 394 F. Supp. at 963.

213. *Id.* at 961.

214. [1979 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,701 (N.D. Ill. 1978); *supra* text accompanying notes 155-56.

availability of their loans was a definite selling point for the investment firm. There was no evidence that the banks made efforts to determine if the investment firm was qualified to design a tax shelter or to counsel investors as to the necessity of registration. The court found irrelevant the fact that the banks undertook their own credit checks of customers and turned down some of them.<sup>215</sup> The threshold issue was the banks' failure to determine the qualifications of the firm to design the tax shelters and to register them.<sup>216</sup>

Some transactions are not structured as loans but nonetheless result in the flow of funds from a bank to its customer. For example, in *H.L. Federman & Co. v. Greenberg*,<sup>217</sup> a Japanese bank allegedly provided a flow of money not through a direct loan but through the purchase of options to purchase the corporation's stock. The court refused to grant a motion by the defendant bank to dismiss for failure to state a cause of action. The option purchases were part of an illegal scheme to funnel the corporation's funds to the corporation's insiders. Although this case did not involve a direct loan, the effect of the option purchases, providing funds for an illegal scheme, was the same.<sup>218</sup>

## 2. Credit Enhancement

The various techniques of credit enhancement also present potential liability for aiding and abetting violations.<sup>219</sup> In connection with a loan, a bank may require, for example, an accommodation party,<sup>220</sup> the subordination of certain debt,<sup>221</sup> or a security interest in or lien on financed or other property. Courts have considered whether a bank's transactions with accommodation parties or debt subordination may subject the bank to aiding and abetting liability.<sup>222</sup> Absent special circumstances, the creation of a security interest or lien on property does not produce securities law problems.<sup>223</sup>

215. *Tucker v. Janota*, [1979 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,701 (N.D. Ill. 1978).

216. *Id.* Neither the underlying credit nor the sophistication of the borrowers was at issue in *Tucker*. See *id.*

217. 405 F. Supp. 1332 (S.D.N.Y. 1975).

218. See *supra* notes 199-200 and accompanying text. No securities laws violations were claimed regarding the option purchases. Plaintiffs based their claim against the Japanese bank on its assistance in securities violations in connection with the plaintiffs' stock purchases.

219. Credit enhancement refers to the various ways in which a bank, either for itself or another, minimizes either the risks of default or the lack of meaningful remedies if a default occurs.

220. See, e.g., *Woodward v. Metro Bank*, 522 F.2d 84 (5th Cir. 1975); see also *infra* text accompanying notes 224-29 (discussion of *Woodward*). An accommodation party is also referred to as a cosignor.

221. See, e.g., *Monsen v. Consol. Dressed Beef Co.*, 579 F.2d 793 (3d Cir. 1978), *cert. denied*, 439 U.S. 930 (1978); see also *infra* text accompanying notes 230-33 and 249-52 (discussion of *Monsen*). When a bank seeks debt subordination, consent of the existing creditor is necessary before subordination may occur.

222. See *infra* text accompanying notes 224-37.

223. The creation of a lien on real property or a security interest in personal property is

An example of a case involving an accommodation party is *Woodward v. Metro Bank*.<sup>224</sup> In *Woodward*, a housewife cosigned a corporation's ninety-day note to a bank and pledged certain of her stock as security for the loan. The loan actually was made to the corporation's officer rather than to the corporation itself, and the officer deposited the money into the corporation's account. The pledge agreement, however, provided that the pledge was "against all indebtedness now owing or which may hereafter become owing" to the bank by the officer as the obligor on the note.<sup>225</sup> The corporation's officer defaulted on subsequent indebtedness and the bank instituted suit against the cosignor. After a full trial on the merits, the Fifth Circuit affirmed the dismissal by the district court of the suit against the bank. The Fifth Circuit did not, however, affirm the district court's rationale.<sup>226</sup> The relevant state law did not impose on the bank a duty of disclosure to the accommodation party, and the court of appeals would not impose such a duty under the guise of federal securities laws.<sup>227</sup> The court stated that not all business transactions "are reducible to a purchase or sale of a security"<sup>228</sup> and that many areas are better left to state laws or other federal laws such as, in this case, the Truth-in-Lending Act.<sup>229</sup>

An example of potential aiding and abetting liability in the context of debt subordination is *Monsen v. Consolidated Dressed Beef Co.*<sup>230</sup> In *Monsen*, a bank encouraged the continuation of a corporation's voluntary payroll deduction plan pursuant to which the employees held unregistered notes of the corporation. The employees were unaware that the payroll deduction plan was subordinated to the debt owed to the bank. The Third Circuit overturned the district court's decision. The district court had granted judgment for the bank notwithstanding the jury's verdict against the bank.<sup>232</sup> The plaintiff had presented evidence at trial that the bank knew of the payroll deduction plan, should have known of the plan's illegality and had the authority to require the corporation to discontinue the plan, but instead the bank improved its secured position by encouraging continuation of the

---

generally a two-party transaction between the debtor and creditor. Indeed, Section 3(a)(5) of the Exchange Act exempts certain mortgages from registration requirements. 15 U.S.C. § 78c(a)(5) (1982). If the property pledged as collateral includes securities, however, the securities laws clearly are applicable.

224. 522 F.2d 84 (5th Cir. 1975).

225. *Id.* at 88.

226. *Id.* In *Woodward*, the district court dismissed the case for lack of jurisdiction because Section 3(a)(10) of the Exchange Act exempted the promissory note from registration. *See* 15 U.S.C. § 78c(a)(10) (1982); *supra* note 200 and accompanying text.

227. *See* TEX. REV. CIV. STAT. ANN. 342-705 (1973). *Id.* at 99. The approach of the Fifth Circuit in *Woodward* is consistent with the Supreme Court's later admonition in *Sante Fe Industries, Inc. v. Green* against the development of a body of federal corporate law. *See* 430 U.S. 462 (1977).

228. 522 F.2d at 91.

229. *Id.* *See* 15 U.S.C. § 1601 *et seq.* (1976) (Truth-in-Lending Act).

230. 579 F.2d 793 (3d Cir. 1978), *cert. denied*, 439 U.S. 930 (1978).

232. *Id.* at 804. The district court's opinion is unpublished.

plan. The Third Circuit found this evidence sufficient to support the jury's verdict. The court of appeals acknowledged that the bank had no duty of disclosure to the employee noteholders. The Third Circuit stressed, however, that the bank required the continuation and subordination of the plan knowing that the corporation would not disclose to the noteholders its deteriorated financial condition and the subordination of the note program.<sup>233</sup>

In a footnote, the Third Circuit distinguished the *Monsen* facts from the facts in *Woodward*.<sup>234</sup> The plaintiff in *Woodward* failed to establish the bank's knowledge of its borrower's fraud whereas the plaintiff in *Monsen* established the bank's close supervision of the unregistered note program. This distinction, however, will not allow a bank to close its eyes to securities laws violations by its borrowers. Once a bank has notice, whether constructive or actual, that a violation may have occurred or is about to occur, the bank should make further inquiry.<sup>235</sup> If the inquiry proves unsatisfactory, the bank should take whatever steps are necessary to cure the violation.<sup>236</sup> Although a defendant should not be liable for aiding and abetting a securities violation solely on the basis of negligent inaction,<sup>237</sup> the cases are inconsistent at best. In addition, a court's determination of where the fine line between negligent and reckless inaction falls is impossible to predict.

### 3. Dissemination of Information

A bank's provision of, or failure to provide, information to others about the bank's customers can also render the bank susceptible to liability for aiding and abetting a violation of the securities laws.<sup>238</sup> In *Pettit v. American Stock Exchange*,<sup>239</sup> the plaintiff alleged that certain Swiss banks aided and abetted the fraudulent sale of securities by allowing the principals to open and maintain dummy accounts, by assisting in concealing the identity of traders in the securities and by aiding in the sale of unregistered securities.

---

233. *Id.* The Third Circuit in *Monsen* looked to the bank's improved position and the noteholders' detriment as well as the bank's ability to control the corporation's continuation or discontinuation of the note program. Even though the bank owed no fiduciary duty to the noteholders, the court did not allow the bank to profit when the bank knew of the securities violation and made no attempt to correct it.

234. *Id.* at 803 n.18.

235. In the situation presented in *Monsen*, the bank does not stand in a fiduciary relationship with the subordinated creditor. *See id.* Because the standard for aiding and abetting liability is whether the bank knowingly and substantially assisted a primary securities violation, inquiry is the first step. If the inquiry results in a reasonable conclusion that no violation occurred or is occurring, the bank should not be held liable for aiding and abetting.

236. In curing the violation of the securities laws that a bank's customer has committed, the bank must be careful not to commit other violations. *See Dirks v. SEC*, 463 U.S. 646 (1983). If the bank is unable to cure the violation, the bank must somehow ensure that its actions do not substantially assist the underlying violation.

237. *See supra* text accompanying notes 137-79.

238. The bank must also be concerned with its duty of confidentiality. *See* 12 U.S.C. § 3403 (1978).

239. 217 F. Supp. 21 (S.D.N.Y. 1963).

The federal district court held that these allegations were sufficient to permit denial of the defendants' motion to dismiss for failure to state a cause of action. Although this case involved more than concealing certain information, the concealment was considered a crucial element of the case.<sup>240</sup>

In *Grimes, Hooper & Messer, Inc. v. Pierce*,<sup>241</sup> the Ninth Circuit in a one-page opinion affirmed the district court's dismissal of suit under Rule 10b-5 against a bank for aiding and abetting a swindle by a short-seller. The bank allegedly permitted certain brokers to believe that their mutual customer was "a man of means and probity."<sup>242</sup> The plaintiffs claimed that the deception was undertaken for the purpose of creating a false aura of financial and moral responsibility. The court did not detail its reasons for its summary dismissal. From *Pettit* and *Grimes* one can glean that the alleged aider and abettor must have some reasonably direct relationship with the underlying violation. Providing, or failing to provide, certain necessary information must constitute assistance that is substantial before liability can be invoked.<sup>243</sup>

#### 4. Fiduciary Dealing

Another avenue for recovery against a bank is the bank's misfeasance or inaction when acting in a trust capacity. In *Armstrong v. McAlpin*,<sup>244</sup> the plaintiff alleged churning by an investment manager and aiding and abetting of that violation by the depository trustee of the affected fund and two custodian banks. The trustee's role was limited by the trust deed to serving as the depository for cash received by, and for investments made on behalf of, the funds. The trustee possessed no power to pass on the merit or frequency of investments and also waived its normal handling fee. The Second Circuit held that no aiding and abetting liability existed. The trustee's lack of power over the investments, coupled with its absence of incentive to churn the account, was determinative.<sup>245</sup> In addition, the plaintiff did not establish the liability of the two custodian banks.<sup>246</sup> One bank acted solely at the direction of the trustee and the other bank never transferred funds to any inappropriate party.

The importance of this case should not be understated. The court implicitly recognized that not all of the parties involved in a particular transaction or series of transactions are sufficiently related to the underlying violation to justify the imposition of liability. The Second Circuit examined whether the underlying violation was a cause of the plaintiff's loss and, if

---

240. *Id.* at 30-31.

241. 519 F.2d 1089 (9th Cir. 1975).

242. *Id.*

243. *See supra* text accompanying notes 121-65.

244. 699 F.2d 79 (2d Cir. 1983).

245. *Id.* at 92.

246. *Id.* at 92-93. The court dismissed the actions against the banks for the plaintiff's lack of specificity in the pleadings. Based on the ambiguous facts before the court, no liability was established.

so, whether the secondary defendant's knowledge of the underlying violation and knowing and substantial assistance were sufficient to justify the imposition of liability.<sup>247</sup> As one court stated, "substantiality is a function of all the circumstances."<sup>248</sup> Other slightly varied factual situations, however, may not produce the same result.

### 5. Direct Aid

Direct aid by affirmative action of a conscious scheme to defraud presents a fifth scenario which may lead to aiding and abetting liability. Courts have not had difficulty in deciding such cases. Perhaps the best example of this type of case is *Carroll v. First National Bank*.<sup>249</sup> *Carroll* involved a fraud in which the defendants caused the plaintiffs to finance a credit bubble in connection with purchases by the principal defendants from plaintiffs of large amounts of securities for speculative purposes.<sup>250</sup> The defendant bank did not purchase securities for its own account but was in a unique position to obtain a delay of time between the purchase date and actual payment. During the delay, the principal defendants expected the value of the securities to rise.<sup>251</sup> Payments were to be made by the bank against delivery of the securities but the bank delayed payment by giving assurances that arrangements for payment were either unavoidably delayed or in progress. The bank also arranged for undisclosed or fictitious persons to bail out certain overdue transactions. The scheme failed in a falling market and the lawsuit ensued.<sup>252</sup>

*Carroll* exemplifies the classic aiding and abetting case. The underlying violations were clear. The bank obviously knew of the underlying violations and its positive assistance was both substantial and knowing. The bank had no reasonable commercial rationale for its actions, indicating the bank's knowing complicity in the fraudulent scheme.<sup>253</sup> This is the type of behavior that Congress and the courts clearly want to prohibit.

*Rosen v. Dick*<sup>254</sup> is another example of aiding and abetting liability in a transaction lacking commercial reasonableness. In *Rosen*, the defendant bank was aware of embezzlement by the president of a target corporation in a takeover attempt. The bank allegedly aided in the embezzlement by not reporting it to the acquiring corporation. In imposing liability on the bank, the district court stated that the law did not require the plaintiff to prove any affirmative duty to the bank to disclose the embezzlement to establish causation. The *Rosen* court stated, "Secondary liability under the federal

---

247. *Id.* at 91-92.

248. *Woodward v. Metro Bank*, 522 F.2d 84, 97 (5th Cir. 1975).

249. 413 F.2d 353 (7th Cir. 1969), *cert. denied*, 396 U.S. 1003 (1970).

250. *See supra* note 131 (explanation of a credit bubble).

251. 413 F.2d at 355-56.

252. *Id.* at 356.

253. *Id.*

254. [1974-1975 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 94,786 (S.D.N.Y. 1974).

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.<sup>255</sup> The bank had no apparent commercially reasonable rationale for its conduct.

The extension of liability to transactions that are commercially reasonable, however, is more tenuous. Commercial reasonableness is relevant to the defendant's knowledge of the underlying violation. In transactions that are commercially reasonable, courts should require plaintiffs to meet the higher standard of conscious intent.

### B. Extension of Doctrine to Other Banking Practices

The principles of the cases may be extended fairly easily to other current banking practices. One of the foremost areas in which this extension is likely to occur is in the area of loans to corporate raiders in attempted acquisitions or to target companies in defending against takeovers. Another area giving rise to potential aiding and abetting liability is the increased underwriting activity by banks either pursuant to, or notwithstanding, the Glass-Steagall Act.<sup>256</sup>

*Rosen* laid the foundation for the imposition of liability in the takeover context.<sup>257</sup> The law in this area is developing daily as the present *Unocal* litigation suggests.<sup>258</sup> As banks increasingly become defendants in the litigious battles fought for corporate control, each bank should be aware of the potential causes of action involved in each takeover to which the bank is a direct or even remote party. If the takeover appears to contain the potential for rendering the bank liable for aiding and abetting a securities law violation, the banks may want to negotiate for certain advance protections from liability from other parties to the extent the law and the circumstances of the transaction permit.<sup>259</sup>

The expansion of underwriting practices by financial institutions also further exposes such institutions to securities law liability.<sup>260</sup> As banks seek

255. *Id.* But see *Woodward v. Metro Bank*, 522 F.2d 84 (5th Cir. 1975) (regarding duty of disclosure on bank).

256. Glass-Steagall Act, ch. 89, 48 Stat. 162 (1933) (codified as amended in scattered sections of 12 U.S.C.). See *supra* note 193 and *infra* note 260.

257. See *supra* text accompanying note 254.

258. *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946 (Del. 1985).

259. Indemnification for securities law violations is not allowed in all circumstances and may be limited by public policy considerations. See *SEC Statement*, 17 C.F.R. § 230.460; *Globus v. Law Research Service, Inc.*, 442 F.2d 1346 (2d Cir. 1971); Note, *Indemnification of Underwriters and § 11 of the Securities Act of 1933*, 72 YALE L. J. 406 (1963).

260. Presently banks may underwrite certain governmental securities. 12 U.S.C. § 24(7) (1982). Banks also are beginning to engage in practices that are similar to underwriting but which technically do not fall within the general prohibition against public underwritings by banks. See, e.g., Federal Reserve System, *Statement Concerning Applicability of the Glass-Steagall Act to the Commercial Paper Placement Activities of Bankers Trust Company*, FED. BANKING L. REP. ¶ 86,270, at 90,823-37 (June 4, 1985) (discussing certain private placement activities). See generally, Comment, *supra* note 193; Note, *supra* note 193.

to gain the benefits of such underwriting-type practices, they must also accept the potential liabilities. The laws and requirements applicable to traditional underwriters will now also apply to banks. The attractiveness of banks as deep-pocket defendants balanced by the public trust placed in the banking industry, particularly by a bank's own depositors, indicate that banks must exercise considerable caution in this area.<sup>261</sup>

### C. Hypothetical Situations

Two hypothetical debt financing alternatives for a business expansion illustrate the potential concerns of the lender and present distinct securities considerations. These are a loan directly from a bank or a public offering of debt securities supported by a bank's letter of credit. In either scenario, the bank absorbs the credit risk. The bank probably also treats each alternative similarly except for certain documentation. In assessing the potential for liability as an aider and abettor of a securities law violation, however, the two alternatives require separate analysis.

#### 1. Loan

The bank has several basic considerations in avoiding aiding and abetting liability in a standard loan transaction. The primary consideration is the relationship of the proposed debt to the business' other debt and equity. For example, the bank should consider whether the creation of debt violates any provision of any charter, bylaws, shareholder agreement, partnership agreement, trust indenture, loan document or other agreements of the obligor, cosignor, guarantor or other related party and whether any securities violation in connection with any subordinated debt or equity has occurred. A second consideration is the use of the proceeds of the loan. For example, will the proceeds of the loan be used to commit any securities violation<sup>262</sup> or to invest in a security in connection with which a violation has been committed? A third consideration is the collateral for the loan. If a security is pledged as collateral, has there been any violation with respect to that security? These are only a few questions that must be asked in each loan transaction. These questions also demonstrate the potential problems that variations in each transaction's facts and circumstances may raise.

#### 2. Credit Enhancement

Debt financing supported by a bank's letter of credit is the second financing alternative discussed above. The letter of credit itself is a security which is exempt from registration under Section 3(a)(2) of the Securities Act

---

261. See Federal Reserve System, *Statement Concerning Applicability of the Glass-Steagall Act to the Commercial Paper Placement Activities of Bankers Trust Company*, FED. BANKING L. REP. ¶ 86,270, at 90,823-37 (June 4, 1985).

262. See *supra* notes 201-18 and accompanying text.



if issued by a domestic bank.<sup>263</sup> The security for which the letter is being issued can be the basis for aiding and abetting liability despite the letter of credit's exemption from registration requirements.<sup>264</sup> Thus two layers of considerations emerge. First, because the letter of credit is in effect a loan, the considerations discussed above regarding loans are applicable. Second, any violation in connection with the underlying debt security may give rise to aiding and abetting liability of the bank. The second layer of considerations dictates that among other things the bank and its counsel examine the debt offering for compliance with all securities laws.

#### IV. CONCLUSION

Banks and other financial institutions have increasingly faced lawsuits alleging aiding and abetting various securities law violations. As deep pockets, such institutions are natural targets of plaintiffs who have lost money and are left with judgment-proof debtors as primary defendants when the investments turn sour. Notwithstanding this natural tendency, the courts must examine fully the allegations in accordance with the analytical model set forth herein. Otherwise financial institutions may become insurers of the securities market with no method to determine in advance the permissible parameters in which to operate.

The economic realities of the marketplace must be observed. The Fifth Circuit in the hallmark case of *Woodward* recognized these realities in rejecting a liberal approach to aiding and abetting liability for financial institutions. In most commercial banking transactions banks will not have the scienter necessary for the imposition of liability. *Woodward* requires the aider and abettor to have knowledge of the underlying violation as well as knowledge that the assistance rendered is a facet of that violation. Some courts, however, are slowly chiselling away at the *Woodward* doctrine notwithstanding the Supreme Court's imposition of judicial restrictions in the series of recent decisions discussed above.

Commercial reasonableness of bank's actions in transactions should be important. This, of course, impacts upon the element of scienter. The securities laws were never intended to provide a moral code of banking ethics but as the banking industry branches further into the securities arena, the industry must remember that the securities laws will affect it. Financial institutions cannot hide behind a banking cloak to insulate themselves from securities liability but commercial reasonableness and business justification should be critical factors.

---

263. 15 U.S.C. § 77c(a)(2) (1982). The "fraud" sections of the securities acts, however, still apply to the letter of credit. The fraud sections of the securities acts include Sections 11, 15 U.S.C. § 77k (1982), 12, *id.* § 77l and 17, *id.* § 77q, of the Securities Act and Section 10, *id.* § 78j, of the Exchange Act.

264. 15 U.S.C. § 77c(a)(2) (1982).

The need for financial institutions to be able to determine in advance the permissible parameters is paramount. Because one of the basic policies underlying the allowance of private civil actions is deterrence, participants, including secondary participants, in the securities markets must have some framework within which to pattern their actions. The theory of an efficient marketplace assumes knowledge of the legal rules within which each individual must operate. A failure to define clearly these legal rules not only results in an inefficient marketplace but also allocates risks unfairly.

