1987

Lenders' Liability for Aiding and Abetting Rule 10b-5 Violations: The Knowledge Standard

John H. Karnes Jr.

Follow this and additional works at: https://scholar.smu.edu/smulr

Recommended Citation
https://scholar.smu.edu/smulr/vol41/iss3/5
LENDERS' LIABILITY FOR AIDING AND ABETTING RULE 10b-5 VIOLATIONS:
THE KNOWLEDGE STANDARD

by John H. Karnes, Jr.

Increasing judicial concern for victimized investors1 over the last two decades has prompted courts to expand the original private cause of action based upon rule 10b-52 to encompass secondary3 parties.4 One result of this expansion is that courts recognized liability for aiding and abetting another party's violation of rule 10b-5.5 Courts have distilled the ele-

---

2. Securities Exchange Commission Rule 10b-5, 17 C.F.R. § 240.10b-5 (1986), provides that:
- 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,
  - To employ any device, scheme, or artifice to defraud,
  - 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
  - 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.
3. Courts draw a distinction between primary parties and peripheral, or secondary, parties. SEC v. Coffey, 493 F.2d 1304, 1314-16 (6th Cir. 1974). The primary party to a 10b-5 violation is that individual, or group of individuals, that actually perpetrates a fraud upon an investor. Id. at 1314. A secondary party, on the other hand, does not actively participate in a scheme to defraud an investor, but rather facilitates the primary party's activity. Id. The distinction between primary and secondary parties is useful only in determining respective standards of liability. Some federal criminal statutes punish secondary parties as principals or primary parties. 18 U.S.C. § 2(a) (1982) ("[w]hoever commits an offense against the United States or aids, abets . . . or procures its commission, is punishable as a principal"). Under federal securities law, primary and secondary parties are jointly and severally liable for any judgment. SEC v. Scott Taylor & Co., 183 F. Supp. 904, 909 (S.D.N.Y. 1959); Comment, Rule 10b-5 Liability After Hochfelder: Abandoning the Concept of Aiding and Abetting, 45 U. Chi. L. Rev. 218, 219 (1977).
5. See SEC v. Seaboard Corp., 677 F.2d 1301, 1312-13 (9th Cir. 1982); Woodward v. Metro Bank, 522 F.2d 84, 94-97 (5th Cir. 1975); SEC v. Coffey, 493 F.2d 1304, 1316 (6th Cir. 1974), cert. denied, 420 U.S. 908 (1975); Brennan, 259 F. Supp. at 680-81; 5 A. Jacobs, THE
ments of their new rule 10b-5 aider and abettor liability into a three-pronged test.\textsuperscript{6} The three-pronged test imposes liability if a primary party violates rule 10b-5, if the alleged aider and abettor possesses some degree of awareness of the primary party's violation, and if the alleged aider and abettor lends substantial assistance to the violation.\textsuperscript{7} This Comment suggests an appropriate scienter requirement that courts should superimpose over the three-pronged aider and abettor test in order to make the test more equitably allocate secondary liability for another's rule 10b-5 violation. The analysis places special emphasis on the particular problems that the current state of aider and abettor liability creates for lenders.

Plaintiffs testing the limits of the aider and abettor doctrine are assailing certain relationships with growing frequency.\textsuperscript{8} One such relationship is that between a lender and borrower. \textit{Metge v. Baehler}\textsuperscript{9} illustrates the type of factual setting ripe for accusations of aider and abettor liability against a lender in connection with a fraud perpetrated by its borrower. In \textit{Metge} a bank extended a substantial loan to a borrower and consequently gained access to comprehensive financial information concerning the borrower's business operations. When the borrower encountered financial difficulties, the bank pursued a series of banking strategies, including extending additional loans to the borrower, in an effort to keep the borrower out of bankruptcy, and therefore, salvage the bank's original loan. Throughout the entire time the bank struggled to preserve the borrower, the borrower issued securities, that, due to the borrower's precarious financial situation, may have been worthless.

Upon the borrower's declaration of bankruptcy, the security holders sued the bank, arguing that the bank, by virtue of its relationship with the borrower, knew that the securities were worthless. The investors alleged that the bank aided and abetted the borrower's rule 10b-5 violation by remaining silent while continuing to fund the borrower's operation. As a result, the investors alleged, the bank allowed the borrower to continue to issue worthless securities, the proceeds of which the borrower in turn used to repay the borrower's debt to the bank. The facts in \textit{Metge} demonstrate that banking relationships, even if innocent, create a potential for accusations of aiding

\textsuperscript{6} For a complete discussion and critique of the three-prong test, see \textit{infra} notes 64-131 and accompanying text.


\textsuperscript{9} 762 F.2d 621 (8th Cir. 1985).
and abetting because lenders possess comprehensive knowledge of those entities with which they transact business and because, perhaps most importantly for plaintiffs, lenders have a dubious distinction as deep pockets.

The precise level of knowledge that courts require for imposing secondary liability is the most crucial aspect of the three-pronged test applied to lenders accused of aiding and abetting a rule 10b-5 violation. If courts establish an unrealistically low level of requisite awareness, the lender who fails to disclose information concerning its borrower's conduct is confronted with the awkward burden of proving a negative.

This Comment first outlines the evolution and current state of the aider and abettor doctrine under federal securities laws in order to gain insight on its justifications and its logical limits. The Comment next demonstrates that the existing framework for imposing aider and abettor liability is ill-suited to accommodate the tenuous lender-borrower relationship. This framework consequently creates an unacceptably high risk that courts will impose liability on lenders in inappropriate situations. The Comment further argues that because the rule 10b-5 aider and abettor doctrine is founded on faulty reasoning and misconstruction of congressional intent, the doctrine itself is not justified. Finally, this Comment urges courts to impose aider and abettor liability on secondary parties such as lenders only upon the plaintiff's successful proof that the lender actually knew of the primary party's fraud and knowingly lent substantial assistance toward its commission.

I. THE EVOLUTION OF AIDER AND ABETTOR LIABILITY UNDER SECTION 10(b)

In order to understand the basis for the rule 10b-5 doctrine of aider and abettor liability, and hence the necessity for courts to provide additional safeguards as they expand the doctrine to encompass more attenuated commercial relationships, one must first understand how existing notions of rule 10b-5 aider and abettor liability evolved. Through rule 10b-5 the SEC makes unlawful the use of fraudulent practices in the purchase or sale of a security. Although Congress intended only administrative remedies for violation of section 10(b), the courts have subsequently implied a private cause of action against primary perpetrators of a rule 10b-5 violation. All circuits agree that primary parties to a fraud should be liable under rule 10b-5.12

12. See, e.g., Austin v. Loftsgaarden, 768 F.2d 949, 957-59 (8th Cir. 1985) (private 10b-5 action is against defrauder), rev'd sub nom. Randall v. Loftsgaarden, 446 U.S. 112, 114 (1986) (issue of primary party liability unaffected); Salcer v. Environ Equities Corp., 744 F.2d 935,
With respect to courts' imposition of liability on secondary parties, such as lenders, however, the circuits are divided because in drafting the rule the SEC neither specifically prescribed nor precluded courts' imposition of liability on remote parties. Consequently, courts' willingness to impose liability on secondary parties varies from circuit to circuit and from court to court. A court's willingness to expand rule 10b-5 to cover secondary parties is reflected in the quantum of knowledge that it requires the secondary party to possess with regard to the second and third prongs of the three-pronged test before the court will impose liability upon the party as an aider and abettor. Courts disinclined to expand rule 10b-5 limit the application of the aider and abettor doctrine by imposing liability upon only those secondary parties who actually knew about or, in some cases, intended to further the underlying fraud. On the other hand, courts willing to expand the rule impose liability on secondary parties who are merely reckless as to their contribution to the underlying fraud.

---

939 (2d Cir. 1984) (10b-5 proscribes fraud by issuer), judgment vacated and remanded, 106 S. Ct. 3324, 92 L. Ed. 2d 731 (1986); Dupuy v. Dupuy, 551 F.2d 1005, 1024 (5th Cir.) (party who conducts fraud is liable under rule 10b-5), cert. denied, 434 U.S. 991 (1977).


Although Rule 10b-5 provides for liability when the primary party perpetrates a violation indirectly, this is not secondary liability. Perpetrating an indirect rule 10b-5 violation might consist of using an unwilling instrumentality to consummate the fraud. A secondary party, on the other hand, may not partake in the fraud, but rather may simply fail to intervene to stop it. See Ruder, supra note 4, at 617 n.80 (arguing that congress used the term "indirect" to accommodate situations in which the defrauder accomplishes the fraud tacitly).

14. Compare Rolf v. Blyth, Eastman Dillon & Co., 570 F.2d 38, 44 (2d Cir.) (recklessness suffices under certain circumstances, such as when a fiduciary duty exists), cert. denied, 439 U.S. 1039 (1978); Herrn v. Strafford, 663 F.2d 669, 684-85 (6th Cir. 1981) (reckless supports aider and abettor liability); SEC v. Seaboard Corp., 677 F.2d 1301, 1302 (9th Cir. 1982) (approving 10b-5 liability for one who recklessly aids and abets); with Woodward v. Metro Bank, 522 F.2d 84, 95-96 (5th Cir. 1975) (danger of over inclusiveness mandates courts to require actual knowledge); Kerbs v. Fall River Indus., Inc., 502 F.2d 731, 740 (10th Cir. 1979) (aider and abettor liability requires knowing assistance); see also Metge v. Bachler, 762 F.2d 621, 625 n.1 (8th Cir. 1985) (withholding judgment on the issue).

15. Compare Rolf v. Blyth, Eastman Dillon & Co., 570 F.2d 38, 44 (2d Cir.) (recklessness suffices), cert. denied, 439 U.S. 1039 (1978), with Edwards & Hanly v. Wells Fargo Sec. Clearance Corp., 602 F.2d 478, 484-85 (2d Cir. 1979) ("[W]e held that 'recklessness' may be an appropriate standard for scienter when there is a fiduciary duty, but we have gone no further. . . . Finding a person liable for aiding and abetting a violation of 10b-5 . . . requires something closer to an actual intent to aid in a fraud . . . .). Compare McLean v. Alexander, 599 F.2d 1190, 1197 (3d Cir. 1979) (scienter defined as recklessness) with Monsen v. Consol. Dressed Beef Co., 579 F.2d 793, 799 (3d Cir. 1978) (aider and abettor must have knowledge of wrong and knowingly assist it), cert. denied, 439 U.S. 930 (1978). Compare Stokes v. Lokken, 644 F.2d 779, 783 (8th Cir. 1981) (aider-abettor need only be reckless) with Berdahl v. SEC, 572 F.2d 643, 647 (8th Cir. 1978) (knowledge is required for aider-abettor liability).

16. Woodward v. Metro Bank, 522 F.2d 84, 95 (5th Cir. 1975) (to prevent liberal expansion of aider and abettor liability only the knowing aider and abettor is liable); accord Landy v. FDIC, 486 F.2d 139, 162 (3d Cir. 1973) (expressing a desire to limit the application of aiding and abetting liability by requiring knowing conduct), cert. denied, 416 U.S. 960 (1974).

17. Woodward v. Metro Bank, 522 F.2d at 96 (if the defendant is accused of aiding and abetting through silence or inaction, then proof of actual intent to aid and abet is necessary).

Courts began integrating the aider and abettor doctrine into federal securities law in enforcement proceedings to enjoin the acts of secondary parties knowingly assisting in another's perpetration of a securities fraud. The SEC first used the doctrine of aider and abettor liability to enjoin the operations of security salesmen who were facilitating a dealer's illegal distribution of stock. In these early decisions the courts analogized to general notions of aiding and abetting under criminal law as support for their holdings. Wielding criminal law concepts, one court enjoined the acts of defendants who did not actually commit a violation of rule 10b-5, but who, according to the court, knew of its existence, participated in it, and desired its success.

*Brennan v. Midwestern United Life Insurance Co.* provided the catalyst for the courts' development of the modern doctrine of aider and abettor liability under rule 10b-5 in civil contexts. The defendant in *Brennan*, Midwestern United Life Insurance Company, discovered that a securities dealer who traded heavily in the corporation's stock was shorting its investors' Midwestern stock. On several occasions Midwestern threatened to inform the state securities board of the dealer's exploits. Midwestern abruptly changed its attitude, however, when it realized such a scandal might endanger pending merger negotiations by reducing the abnormally high price of Midwestern stock. Consequently, not only did Midwestern fail to report the dealer as it threatened, but it also persuaded its dissatisfied shareholders to direct their complaints to the dealer himself, rather than to the state securities board. As a result of Midwestern's actions, the dealer was able to identify those investors that were most likely to complain to the authorities. This knowledge allowed the dealer to perpetuate his scheme by actually purchasing just enough stock to appease disgruntled investors while embezzling the funds of those investors that never grew suspicious about the dealer's non-delivery. As a result, none of the investors complained to the state securities board. By the time the authorities uncovered the dealer's scheme, the dealer had absconded with the investments of many of Midwestern's shareholders. In denying Midwestern's motion to dismiss the investors' 10b-5 claim against it, the *Brennan* court held that the investors had stated a cause of action against Midwestern as an aider and abettor of the dealer's fraudulent scheme. In so doing, however, the court acknowledged that the holding was supported neither by the explicit terms of section 10(b) of the Act nor by

---

19. See SEC v. Frank, 388 F.2d 486 (2d Cir. 1968) (action to enjoin attorney from distributing misleading information concerning client corporation); Timetrust, Inc. v. SEC, 142 F.2d 744 (9th Cir. 1944) (first aider and abettor action to enjoin corporations from selling bank stock pursuant to a fraudulent installment plan).
21. Id. at 746 (court analogized to criminal aiding and abetting to enjoin actions of secondary partie); accord *In re Burley & Co.*, 23 S.E.C. 461, 468 n.11 (1946) (aider and abettor condemnation by criminal law also creates a violation of rule 10b-5 because "anyone who aids and abets another's violation of a law has himself violated that law").
22. *Timetrust*, 142 F.2d at 748.
24. See id. at 675-83.
the legislative intent behind the statute.\textsuperscript{25}

Instead, the court characterized its imposition of secondary liability upon Midwestern as a logical extension from the private cause of action that courts previously implied under rule 10b-5.\textsuperscript{26} Rule 10b-5, according to the court, serves merely as a mechanism for the court's expansion of federal common law remedies.\textsuperscript{27} The court reasoned that because federal common law implies a remedy from the violation of a right, the perpetration of a fraud that rule 10b-5 prescribes warrants a remedy.\textsuperscript{28} Although subsequent decisions cited \textit{Brennan} as a precedent for much broader liability,\textsuperscript{29} the court arguably limited its holding to the situation in which a fiduciary secondary party benefits from the primary party's fraud while knowingly and affirmatively aiding and abetting the fraud's perpetration.\textsuperscript{30} The \textit{Brennan} court's holding assumed that Midwestern benefited from its tacit agreement with the dealer by avoiding a scandal that might have compromised pending merger negotiations.\textsuperscript{31} The court further found that in so doing Midwestern knowingly assisted the dealer's perpetration of a fraud against the corporation's shareholders.\textsuperscript{32}

The \textit{Brennan} opinion is particularly noteworthy today because the court identified section 876 of the Restatement (Second) of Torts\textsuperscript{33} as the basis for extending liability to parties peripheral to the fraud. Section 876 imposes secondary liability for personal injury against any person who is aware that the tortfeasor is breaching a duty to the victim and who offers substantial assistance in the tortfeasor's infliction of the injury.\textsuperscript{34} The \textit{Brennan} analogy to secondary liabilities under tort law currently provides the primary justifi-

\textsuperscript{25} Id. at 680 ("[O]ne can search the statute in vain for language indicating that a violator of Section 10(b) and Rule 10b-5 should be liable in a civil action for damages. Such liability was developed by the courts on general principles of tort law.").

\textsuperscript{26} Id. at 679-80.

\textsuperscript{27} Id.

\textsuperscript{28} Id.

\textsuperscript{29} IIT v. Cornfeld, 619 F.2d 909, 921-22 (2d Cir. 1980) (citing \textit{Brennan} for imposing liability for merely knowing of fraud and failing to warn victim); Rolf v. Blyth, Eastman Dillon & Co., 570 F.2d 38, 44 (2d Cir.) (citing \textit{Brennan} for imposition of liability when no cognizable benefit accrued to aider and abettor), \textit{cert. denied}, 439 U.S. 1039 (1978).


\textsuperscript{31} 259 F. Supp. at 675.

\textsuperscript{32} Id.; see Landy v. FDIC, 486 F.2d 139, 161 (3d Cir. 1973) (\textit{Brennan} court imposed aider-abettor liability on a finding of actual knowledge plus affirmative inquiries from those to whom the defendant owed a fiduciary duty), \textit{cert. denied}, 416 U.S. 960 (1974).

\textsuperscript{33} \textit{RESTATEMENT (SECOND) OF TORTS} § 876 (1977) [hereinafter \textit{RESTATEMENT (SECOND)}].

\textsuperscript{34} 259 F. Supp. at 680. \textit{RESTATEMENT (SECOND), supra} note 33, § 876 states:

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

(a) does a tortious act in concert with the other or pursuant to a common design with him, 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.
cation for aider and abettor liability in securities actions.\textsuperscript{35}

In \textit{SEC v. Coffey}\textsuperscript{36} the Sixth Circuit expanded the rule in \textit{Brennan} by formulating the first of several existing three-pronged tests for determining aider and abettor liability under rule 10b-5. According to \textit{Coffey} a secondary party may be deemed liable as an aider and abettor if the primary party violates rule 10b-5, if the secondary party has a general awareness of the violation, and if the secondary party knowingly lends substantial assistance to the execution of the wrong.\textsuperscript{37} The \textit{Coffey} test fails to incorporate the additional requirements of fiduciary duty, benefit, and actual knowledge of the fraud upon which the \textit{Brennan} court implicitly based its decision.\textsuperscript{38}

\textit{Woodward v. Metro Bank}\textsuperscript{39} was the first major case to recognize the need to restrict the aider and abettor doctrine in order to accommodate the competing investor and business interests that arise in a commercial context. The \textit{Woodward} court asserted that courts exceeded congressional intent by creating secondary liability under rule 10b-5.\textsuperscript{40} Although the court embraced the aider and abettor doctrine in theory,\textsuperscript{41} it warned other courts against expanding the doctrine to impose liability based on the attenuated relationships that develop in commercial transactions.\textsuperscript{42} The courts' continued expansion of the aider and abettor doctrine would, according to the \textit{Woodward} court, ultimately interfere with vital areas of commercial law.\textsuperscript{43}

In order to curtail the expansion of the aider and abettor doctrine, the \textit{Woodward} court adopted the \textit{Coffey} test with two significant modifications.\textsuperscript{44} First, in addition to requiring the plaintiff to prove the primary

\begin{itemize}
\item \textsuperscript{35} SEC v. Seaboard Corp., 677 F.2d 1301, 1310 (9th Cir. 1982) (tort law supports the recognition of rule 10b-5 aider and abettor liability); Woodward v. Metro Bank, 522 F.2d 84, 91 (5th Cir. 1975) (rule 10b-5 aider and abettor liability is founded on tort); 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), \textit{cert. denied}, 397 U.S. 989 (1970); \textsc{A. Bromberg \& L. Lowenfels}, \textit{supra} note 11, \textsection 8.5.
\item \textsuperscript{36} 493 F.2d 1304 (6th Cir. 1974), \textit{cert. denied}, 420 U.S. 908 (1975).
\item \textsuperscript{37} 493 F.2d at 1316.
\item \textsuperscript{38} See \textit{IIT v. Cornfeld}, 619 F.2d 909 (2d Cir. 1980) (imposing liability for merely knowing of fraud and failing to warn victim); \textit{Rolf v. Blyth, Eastman Dillon \& Co.}, 570 F.2d 38, 44 (2d Cir.) (imposing liability when no cognizable benefit accrued to aider and abettor), \textit{cert. denied}, 439 U.S. 1039 (1978); Woodward v. Metro Bank, 522 F.2d 84, 90-91 (5th Cir. 1975) (imposing liability without finding benefit to the aider and abettor); \textit{SEC v. Coffey}, 493 F.2d 1304, 1316 n.29 (6th Cir. 1974) (citing \textit{Brennan} for adoption of \textsection 876 of \textit{Restatement (Second) without requiring intent to aid or receipt of benefit), \textit{cert. denied}, 420 U.S. 908 (1975); \textit{Landy v. FDIC}, 486 F.2d 139, 161 (3d Cir. 1973) (no mention of benefit to aider and abettor), \textit{cert. denied}, 416 U.S. 960 (1974).
\item \textsuperscript{39} 522 F.2d 84 (5th Cir. 1975).
\item \textsuperscript{40} \textit{Id.} at 99 n.33. The \textit{Woodward} court stated: "Actually, Congress and the Commission probably never intended that the rule be extended as far as it has been." \textit{Id.} (citing \textit{Ruder}, \textit{supra} note 5, at 627).
\item \textsuperscript{41} \textit{Id.} at 99. After discussing the paucity of legislative history for rule 10b-5, the \textit{Woodward} court noted: "We neither desire nor would we be able to cut back on the established scope of 10b-5. However, we can refuse to create a new, sweeping expansion of the Rule which will pre-empt significant areas of commercial law." \textit{Id.} at 99 n.33.
\item \textsuperscript{42} \textit{Id.} at 98-99.
\item \textsuperscript{43} \textit{Id.} at 99 n.33.
\item \textsuperscript{44} \textit{Id.} at 94-95. The \textit{Woodward} test for aiding and abetting may be summarized as: (1) an underlying rule 10b-5 violation; (2) an awareness that one's role in the activity was wrongful; and (3) knowing, substantial assistance.
\end{itemize}
party's rule 10b-5 violation, the Woodward test also requires proof of the accused aider and abettor's knowledge of its role in the wrongful activity. Second, the Woodward test requires the plaintiff to prove that the accused aider and abettor knowingly assisted in the primary party's perpetration of the violation.

II. LENDERS UNDER THE EXISTING FRAMEWORK: A SQUARE PEG IN A ROUND HOLE

The aider and abettor doctrine as currently formulated in variations on the three-pronged test provides an inadequate method for evaluating secondary rule 10b-5 liabilities that may arise from lender and borrower relationships. First, courts founded the rule 10b-5 aider and abettor doctrine upon criminal and tort law notions of secondary liability that are factually and theoretically inconsistent with federal securities law. Furthermore, none of the test's existing prongs fairly allocate liability in attenuated relationships. This section critically examines the propriety of using either tort or criminal law to justify rule 10b-5 aider and abettor liability and then analyzes the inadequacies of the current aider and abettor three-pronged framework as courts apply it to lenders.

A. The Basis of the Aider and Abettor Liability Doctrine

Courts have used both criminal and tort doctrines of aider and abettor liability to justify their imposition of civil aider and abettor liability based upon a violation of rule 10b-5. One commentator argues, however, that compared to securities law violations, the wrongs that courts designed criminal aider and abettor law to accommodate are analytically much simpler than those arising under rule 10b-5. As opposed to rule 10b-5 cases, criminal laws are best suited for resolving basic physical issues such as one's presence and conduct rather than one's state of mind.

More important than the analytical differences existing between conventional criminal and rule 10b-5 fact patterns is the fact that the criminal provisions that fostered the rule 10b-5 doctrine of aider and abettor liability offered a degree of protection from conviction based upon mere unfortunate coincidence that courts failed to adopt into the modern rule 10b-5 aider and abettor doctrine. For example, to convict an individual for criminally aiding and abetting the commission of an offense, the state must generally prove that the secondary party intended to aid the primary perpetrator in committing a crime. Regardless of any other reasons motivating courts to require proof

45. Id.
46. Id.
47. See supra note 21 and accompanying text.
48. See supra notes 33-38 and accompanying text.
49. See Comment, supra note 3, at 242 (arguing that as opposed to criminal law "in the context of modern securities fraud cases, involving intricate schemes in which the actions of several persons are essential to success, the concept of aiding and abetting seems quite artificial, and its utility and purpose less than obvious").
50. In United States v. Peoni, 100 F.2d 401, 402 (2d Cir. 1938), Justice Learned Hand
of actual intent, such a rigorous standard of mens rea reduces the risk that the judicial system will impose guilt on an innocent bystander. Furthermore, the criminal aider and abettor doctrine mitigates the risk of a jury's wrongful imposition of guilt, which is present whenever courts assess the culpability of a secondary party, by punishing the aider and abettor much less severely than the primary perpetrator. The rule 10b-5 aider and abettor doctrine on the other hand, imposes liability on a showing much less rigorous than intent, and such liability is joint and several with the primary party. In creating the rule 10b-5 aider and abettor doctrine, therefore, courts have excerpted the principles of vicarious liability contained in the criminal law doctrine while ignoring the safeguards inherent in the criminal system.

Tort concepts, like criminal law concepts, also serve as poor bases upon which to found a federal securities law theory of secondary liability. Tort law contains no explicit aider and abettor concepts. The tort concepts that held that a defendant aids and abets a crime when "he in some [way] associate[s] himself with the venture, . . . participate[s] in it as in something that he wishes to bring about, . . . [and] seek[s] by his action to make it succeed." The Supreme Court adopted Justice Hand's rendition in Nye & Nissen v. United States, 336 U.S. 613, 619 (1949). See also MODEL PENAL CODE § 242.2 (Official Draft 1962) ("A person commits an offense if he purposely aids another to accomplish an unlawful object of a crime"); accord Landy v. FDIC, 486 F.2d 139, 163-64 (3d Cir. 1973), cert. denied, 416 U.S. 960 (1974); United States v. Austin, 462 F.2d 724, 732 (10th Cir. 1972); Grimes v. United States, 379 F.2d 791, 793 (5th Cir. 1967).

51. Courts are beginning to realize the unfairness that the lack of corresponding procedural protections creates in any aiding and abetting action under federal securities law. In Investors Research Corp. v. SEC, 628 F.2d 168, 177 (D.C. Cir. 1980), the court confronted the knowledge requirement and posited: The awareness of wrong-doing requirement for aiding and abetting liability is designed to insure that innocent, incidental participants in transactions later found to be illegal are not subjected to harsh, civil, criminal, or administrative penalties. This policy is especially germane where the proscribed conduct of the principal may not always appear to be wrongful . . . . Accord SEC v. Coffey, 493 F.2d 1304, 1317 (6th Cir. 1974) (rigorous knowledge requirement prevents participants from dragging innocent parties into a suit), cert. denied, 420 U.S. 908 (1975).

52. Although aiders and abettors are punished as principals under 18 U.S.C. § 2 (1983), important criminal law authorities suggest that the criminal law system should punish the secondary party less severely. See MODEL PENAL CODE § 242.4 (Official Draft 1962) (aiding consumption of a crime "is a felony of the third degree if the principal offense was a felony of the first or second degree. Otherwise it is a misdemeanor.").

53. Stokes v. Lokken, 644 F.2d 779, 782 (8th Cir. 1981) ( aider and abettor liability may be imposed for recklessness); see also Comment, supra note 3, at 234-35 (discussing the difference between standards of intent, knowledge, and recklessness in securities law).


55. RESTATEMENT (SECOND), supra note 33, § 876 deals with contributory tortfeasors who may or may not be aiders and abettors. The comments to § 876 focus on the contributing tortfeasor's assistance, presence at the scene of the tort, the parties' relationship, and the tortfeasor's state of mind. The reference to the commission of a tort and the emphasis on presence in general, demonstrates that the section's drafters did not intend it to resolve the complex, fluid violations that arise under securities law.

One commentator argues that the principles expounded in § 876 apply only to the allocation of liability for distinct physical harms and not more tenuous economic harms. Gilmore & McBride, supra note 54, at 833.
various courts cite as the basis for rule 10b-5 aider and abettor liability merely describe interrelationships sufficient to justify imposition of liability on both parties involved. Further, the policies that courts intended to promote by synthesizing common law tort doctrine are subtly, yet undeniably, different from those that Congress intended to further in promulgating the Act. Moreover, the fissure between these two policies widens as the particular fact situation at issue deviates from the typical fact pattern that tort policies contemplate toward the more complex situations in which Congress has seen fit to apply federal securities policy. As a potential aiding and abetting situation becomes complicated by securities and commercial transactions, tort policies and the policies underlying the Act are likely to create inconsistent outcomes.

B. The Modern Aider and Abettor Action

The Woodward court noted that the rule 10b-5 aider and abettor doctrine is still undefined, and consequently the standard of liability varies from jurisdiction to jurisdiction. Although most jurisdictions confronting the issue...

56. See supra note 35 and accompanying text.
57. The tort analog to aiding and abetting is the area of concerted wrongful action. This doctrine assures that all who act wrongfully in concert, through their presence, assistance, and participation, will bear the liability equally. The cases really deal with instances in which the tortfeasors of equal culpability unite to cause harm rather than those in which a party merely aids the primary tortfeasor. See Thompson v. Johnson, 180 F.2d 431, 433-34 (5th Cir. 1950).

Very little legislative history exists evidencing Congress's precise purposes for enacting the Securities Exchange Act of 1934, 15 U.S.C. §§ 78a-78kk (1982). The protection of investors was indisputably one of Congress's ultimate objectives. See supra note 1 and accompanying text. Identifying Congress's ultimate objective for promulgating the Act does not illuminate the extent to which Congress contemplated interfering with commercial transactions in order to attain its goal. The Acts' legislative history suggests that Congress did not intend to protect investors in disregard of the corresponding cost to business, but rather that Congress intended a balancing between the twin goals of investor protection and relief of the burden on business: "The purpose of this bill is to protect the investing public and honest business . . . ." S. REP. No. 47, 73d Cong., 1st Sess. (1933) (emphasis added), quoted in United States v. Naftalin, 441 U.S. 768, 775 (1979). "Just as important [as the protection of investors] is the tragic effect upon industrial enterprises and the workers who have invested their lives and their labor in [their businesses]." 77 CONG. REC. 2925 (daily ed. May 5, 1933) (statement of Rep. Kelly). Relying on much of this legislative history, the Supreme Court recently stated that "neither this Court nor Congress has ever suggested that investor protection was the sole purpose of the Securities Act." United States v. Naftalin, 441 U.S. 768, 775 (1979) (emphasis in original).
59. Tort policy and securities law policy generally diverge as transactions become less securities transactions and more commercial transactions. The Woodward court stated:

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 . . . . Some transactions, it is only logical to assume, should be left to the operation of these other laws, for Rule 10b-5 was not designed to be the ethical Ten Commandments for all securities transactions.

522 F.2d at 91. Further, "protection of investors is of primary importance, but it must be kept in mind that the nation's welfare depends on . . . a reliable, vigorous business community." Herpich v. Wallace, 430 F.2d 792, 804-05 (5th Cir. 1969).
60. 522 F.2d at 94.
have adopted some form of three-pronged test for liability, no uniform standard of conduct or specified degree of intent or knowledge exists. These various existing tests for aider and abettor liability are generally formulated in terms of awareness, knowledge, and substantial assistance. Accordingly, the degree of conscious participation, intent, and specific conduct that courts require remains open to arguments based on public policy and the purpose of federal securities law. The post-Brennan cases demonstrate that the three-pronged test fails to facilitate the courts' accurate and equitable determination of liability in the context of the relationships between lender and borrower.

1. The First Prong: Existence of an Underlying Violation

The independent securities law violation requirement is the only stable prong of the three-pronged test. Courts agree that a primary party's independent violation of rule 10b-5 is a prerequisite to a secondary party's aider and abettor liability. The underlying violation requirement focuses solely on the primary wrongdoer's conduct and avoids any inquiry into the lender's activities or relationship to the primary party. Because the independent violation requirement is completely objective and independent of the accused aider and abettor's relationship to the perpetrator, the requirement avoids the possibility that a fact finder might infer the lender's participation in its borrower's fraud by virtue of the lender's familiarity with the borrower. As a result, the primary violation prong does not pose any specific risks to commercial finance.

2. The Second Prong: Awareness of the Underlying Violation

In contrast, the awareness requirement is particularly ill-suited for resolving aiding and abetting accusations against remote secondary parties such as lending institutions. The circuits disagree both on the quantum of knowledge, and the object of the knowledge, that a secondary party must possess.

---

61. See supra notes 14-16 and accompanying text.
62. See supra note 44.
63. See Woodward v. Metro Bank, 522 F.2d at 97. See generally Note, Liability for Aiding and Abetting Violations of Rule 10b-5: Recklessness Standard in Civil Damage Actions, 62 Tex. L. Rev. 1087 (1985) (arguing that courts would best serve the policies underlying securities law if they resolved the existing controversy by adopting a recklessness standard).
64. Stokes v. Lokken, 644 F.2d 779, 783 (8th Cir. 1981); Woodward v. Metro Bank, 522 F.2d at 97.
65. Woodward v. Metro Bank, 522 F.2d at 94 (both the Woodward and Coffey tests inquire whether "some other party has committed a securities law violation").
66. See supra note 14-15 and accompanying text.
67. Compare Landy v. FDIC, 486 F.2d 139, 162-63 (3d Cir. 1973) (test is functionally similar to Gross v. SEC with Gross v. SEC, 418 F.2d 103, 107 (2d Cir. 1968) (aiding and abetting requires only awareness of underlying violation) and Cleary v. Perfectune, 700 F.2d 774, 777 (3d Cir. 1983) (knowledge requirement applies to the assistance requirement), cert. denied, 439 U.S. 930 (1978) with Zabriskie v. Lewis, 507 F.2d 546, 554 (10th Cir. 1974) (aiding and abetting requires awareness that assistance will aid fraud). In contrast some courts apply an even more comprehensive standard. See Woodward v. Metro Bank, 522 F.2d at 94-95 (aiding and abetting requires both awareness of underlying violation and that assistance will further violation).
concerning the defrauder's scheme before a court classifies the secondary party as an aider and abettor. Thus, depending on the circuit in which the plaintiff brings its action, the court may require the plaintiff to provide evidence either of the alleged aider and abettor's awareness of the underlying violation, or the degree to which the secondary party knowingly assisted that violation, or both. The circuits also vary on the quantum of knowledge that the plaintiff must show the secondary party possessed. Consequently, any lender that is subject to the jurisdiction of more than one circuit appears potentially vulnerable to aider and abettor liability for varying degrees of awareness about several differing types of conduct. Such conditions make it difficult for an enterprise to chart its conduct so as to avoid liability.

Classifications based on the quantum and the object of the secondary party's knowledge under the three-pronged test exalt form over substance. Such classifications, therefore, transgress the Act's goal of evaluating the economic reality of transactions. Those circuits that impose liability upon secondary parties that knowingly aided and abetted a rule 10b-5 violation, but that, at the same time, had less than actual knowledge of the violation's existence, best illustrate the inequity of the analysis. The existing awareness analysis causes courts to allocate liability based upon rite rather than reality. After all, one can possess actual knowledge of another's rule 10b-5 violation and recklessly aid and abet its commission. Logic dictates, however, that one cannot have less than specific knowledge of a violation's existence and still knowingly assist it. An aider and abettor's awareness of the underlying securities law violation is indispensable to its awareness of its function in the violation, and the quantum of knowledge that courts require of the latter cannot, therefore, logically exceed the former.

Courts now recognize scienter as an element of a primary rule 10b-5 violation. Consequently, a secondary party cannot aid and abet a fraud by negligently failing to uncover it. Thus, a bystander that could discover the

68. See generally Gilmore & McBride, supra note 54, at 828-29 (1985) (elucidating on the distinction between extent of awareness and object of awareness); Comment, supra note 3, at 236-38 (discussing the appropriate knowledge requirement applicable to the second and third prongs of the aider and abettor test).
70. Zabriskie v. Lewis, 507 F.2d 546, 554 (10th Cir. 1974).
71. Woodward v. Metro Bank, 522 F.2d at 94-95.
72. See supra notes 14-15 and accompanying text.
74. See Landy v. FDIC, 486 F.2d 139 (3d Cir. 1973); Gross v. SEC, 418 F.2d 103 (2d Cir. 1968).
76. Ernst & Ernst v. Hochfelder, 425 U.S. at 193; IIT v. Cornfeld, 619 F.2d 909, 923 (2d Cir. 1980) (recklessness satisfies scienter, negligence does not); SEC v. Coffey, 493 F.2d 1304, 1316 n.30 (6th Cir. 1974) (scienter requires higher mental state than negligence), cert. denied,
primary party's fraud using due care would not be liable as an aider and abettor.

Except for the elimination of negligence as a possible standard for imposing aider and abettor liability, the courts' adoption of scienter in rule 10b-5 cases provides courts with little practical aid in assessing whether a lender's extent of awareness of its borrower's fraudulent acts warrants imposing aider and abettor liability on the lender under the knowledge prong of the aider and abettor test. Although scienter constitutes an element of a primary party's rule 10b-5 violation, and although courts refer to a secondary party's knowledge as scienter, it is not clear whether the scienter standard is the same for both the primary and secondary violator. What is more, the circuits are divided over the precise mental states that satisfy the scienter requirement; some circuits require knowledge, some require only recklessness, and some hold that the quantum should vary for secondary liability.

If recklessness constitutes scienter for a primary violation of the rule, and most courts indicate that it does, then recklessness could conceivably also serve as the requisite quantum of knowledge needed to impose liability upon an aider and abettor. Several courts have indicated, however, that scienter for the secondary party should be set higher than for the primary party. If, on the other hand, courts ultimately determine that a primary violation of rule 10b-5 requires actual knowledge, then both fairness and common sense dictate that courts impose corresponding aider and abettor liability on no less than a similar finding. Notably, the culpable quantum of knowledge in criminal law, which fostered the doctrine of aider and abettor liability under

420 U.S. 908 (1975); Lanza v. Drexel & Co., 479 F.2d 1277, 1306 (2d Cir. 1973) (scienter contemplates at least recklessness); Comment, supra note 3, at 236-38.

77. Ernst & Ernst v. Hochfelder, 425 U.S. at 191.

78. See Woodward v. Metro Bank, 522 F.2d at 95.

79. See id. Courts must “scale up” the scienter they require for secondary liability as a party’s actions become more remote from the actual violation. The Woodward court held that “the surrounding circumstances and expectations of the parties are critical” in determining the proper level of scienter, thus intimating that the standard varies from situation to situation. Id. But see Stokes v. Lokken, 644 F.2d 779, 783 (8th Cir. 1981) (scienter is the same for both primary and secondary parties).


81. SEC v. Seaboard Corp., 677 F.2d 1301, 1312 (9th Cir. 1982); Rolf v. Blyth, Eastman Dillon & Co., 570 F.2d 1301, 1314 (2d Cir. 1978).

82. See Stokes v. Lokken, 644 F.2d at 782-84 (knowledge prong refers to Hochfelder's scienter, and is the same as is required for a primary violation; knowing assistance prong, however, requires actual knowledge).


84. See Woodward v. Metro Bank, 522 F.2d at 95-97 (as activity becomes more remote, scienter requirement increases; when activity is ordinary commercial transaction, something approaching intent is required); IIT v. Cornfeld, 619 F.2d 909, 923-24 (2d Cir. 1980).
rule 10b-5, is not mere knowledge, but rather intent to aid in the consumma-
tion of the offense. Presumably, the high criminal law standard defers to the
fact that as physical presence decreases, forcing courts to rely on more cir-
cumstantial evidence to convict, the risk of mistaken judgments increases.85

The knowledge prong of the aider and abettor test particularly disadvan-
tages lenders since the extent of the lender's awareness of its role in a securi-
ties law violation and hence its liability as a potential aider and abettor, is a
question of fact86 for the discretion of a jury. As a result, the knowledge
requirement discriminates heavily against lenders, most of whom are banks,
because banks appear as unsympathetic defendants to jurors. The awareness
requirement allows plaintiffs to establish a doubt in the minds of the jury
regarding a lender's participation in its borrower's fraud simply by showing
that the lender was very familiar with the borrower's finances. In such a
case the lender has the unenviable task of arguing that, in order to prosper, it
must make and administer loans at a minimum of expense. Unfortunately,
loan approval procedures allow banks to scrutinize only their borrowers' sol-
vency, credit history, and motives for obtaining the loan. That a bank may
well possess sufficient information about its borrower's operations to deter-
mine whether they have violated rule 10b-5 is axiomatic. Courts must rec-
ognize, however, that banks do not review their borrowers' finances with an
eye toward fraud, but rather with an eye toward financial stability.87

3. The Substantial Assistance Requirement

An analysis of the substantial assistance requirement illustrates the two
major shortcomings of the current aider and abettor test as it applies to lend-
ers. First, the substantial assistance requirement forces courts to draw a du-
bious distinction between assistance through action and assistance through
inaction.88 A survey of the cases indicates that although drawing such a
distinction is often impossible, the results of a court's classifying a secondary
party's conduct as either action or inaction is generally outcome determina-
tive. Second, notwithstanding the arbitrariness of the distinction between ac-
tion and inaction, the typical plaintiff basis its aider and abettor action
against a lender on the lender's silence or inaction.89 Under existing aider

85. See Landy v. FDIC, 486 F.2d 139, 163-64 (3d Cir. 1973) (suggesting that evidence of
aiding and abetting will necessarily be circumstantial, and that the inferences raised by silence
may tend to implicate innocent bystanders).

86. Globus v. Law Research Serv., Inc., 418 F.2d 1276, 1283 (2d Cir. 1969) (intent to
defraud is a fact issue); see Brennan v. Midwestern United Life Ins. Co., 259 F. Supp. 673, 682
(N.D. Ind. 1966) (alleged aider and abettor's knowledge and assistance are jury questions),

87. But see Gilmore & McBride, supra note 54, at 841 (banks only have access to information
that their borrowers supply; although a borrower's fraud may not be obvious, banks
should be conscious of fraud upon reviewing borrower's files).

88. See infra notes 91-114 and accompanying text.

89. See, e.g., Woods v. Barnett Bank, 765 F.2d 1004, 1006-07 (11th Cir. 1985) (bank
failed to fully explain its relationship with the primary parties); Metge v. Baehler, 762 F.2d
621, 625 (8th Cir. 1985) (bank accused of nondisclosure of borrower's fraud); Woodward v.
Metro Bank, 522 F.2d at 96 (bank accused of failing to warn borrower of fraudulent scheme
concerning its loan).
and abettor principles, however, mere silence does not satisfy the require-
ment of substantial assistance. Consequently, if courts use existing aider
and abettor principles to adjudicate claims against lenders, they will have to
expand the already over-extended rule 10b-5 to cover nonfeasance as a mat-
ter of course.

a. The Action/Inaction Dilemma

The most unworkable component of the current rule 10b-5 aider and abet-
tor doctrine is the distinction that the doctrine requires courts to draw be-
tween assisting a violation with action and assisting it with inaction. As a
rule, courts hold that inaction cannot constitute aiding and abetting absent a
duty to act or specific intent to aid and abet the fraud. If, on the other
hand, a court characterizes a secondary party's assistance as action, then it
may not only impose aider and abettor liability on the party, but in some
jurisdictions it may do so upon a finding of mere recklessness. In reality, a
court's classification of a secondary party's conduct as either action or inac-
tion is often dispositive of the secondary party's liability. The most nag-
ging inadequacy of the current aider and abettor doctrine, therefore, is that
despite the crucial nature of a secondary party's role in a fraud to the issue of
the party's liability as an aider and abettor, no clear distinction exists be-
tween active and passive assistance.

The recent decision in *Metge v. Baehler* demonstrates the importance of
whether a court classifies a lender's conduct as action or inaction. In *Metge*
the defendant bank financed its borrower's purchase of a subsidiary. At the

---

90. Rudolph v. Arthur Anderson & Co., 800 F.2d 1040, 1043 (11th Cir. 1986); Cleary v.
    Perfectune, 700 F.2d 774, 777 (1st Cir. 1983); Woodward v. Metro Bank, 522 F.2d at 94-95;
    SEC v. Coffey, 493 F.2d 1304, 1310 (6th Cir. 1974), cert. denied, 420 U.S. 908 (1975); Strong
    v. France, 474 F.2d 747, 751 (9th Cir. 1973); Wright v. Schock, 571 F. Supp. 642, 663 (N.D.
    Cal. 1983); Rudier, supra note 4, at 645.

91. Commenting on the relationship between the scienter requirement and the substantial
    assistance requirement, one court offered the following caveat:

    Application of the tripartite test should not obscure the basic proposition that
    mere 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.

92. Metge v. Baehler, 762 F.2d 621, 625 (8th Cir. 1985) (scienter when inaction is in-
    volved is high standard of intent); Woodward v. Metro Bank, 522 F.2d at 95 (when defendant
    is accused of aiding through silence, plaintiff must prove that defendant possessed a high stan-
    dard of intent); Mendelsohn v. Capital Underwriters, Inc., 490 F. Supp. 1069, 1084 (N.D. Cal.
    1979) ("[w]ithout evidence that [defendant] did some affirmative act tending to cover up the
    fraud, this Court would hesitate to find substantial encouragement based on evidence of equiv-
    ocal acts accompanied by mere allegations of undisclosed psychic support").

93. See infra notes 95-103 and accompanying text.

94. Metge v. Baehler, 762 F.2d 621, 625 (8th Cir. 1985) (bank inactive despite perpetua-
    tion of the defrauder's existence by a series of banking strategies); Strong v. France, 474 F.2d
    747, 751 (9th Cir. 1973) (though promoter of corporation signed a letter containing misrepre-
    sentations and joined the board of an inchoate corporation, his conduct was inactive); Feldman
    defrauder was not action); accord Comment, supra note 3, at 241 n.165.

95. 762 F.2d 621 (8th Cir. 1985).
outset the bank discovered that the borrower had a severe cash flow problem, but that the borrower was nonetheless issuing mortgage-backed securities to the public. Over time the borrower's financial condition deteriorated, and the bank protected its interest by taking an active role in the borrower's finances. Eventually, the bank was receiving quarterly financial statements from the borrower and arranging loan strategies to perpetuate the borrower's operations. Given the information contained in the borrower's financial statements, the bank arguably could have discerned that the securities that the borrower was issuing were worthless. When the borrower finally went bankrupt, the holders of the worthless securities brought suit against the bank, arguing that the bank aided and abetted the borrower's fraud by failing to disclose that the securities were worthless and by perpetuating its borrower's existence through loans.

At trial the investors produced evidence indicating that the borrower might have used at least some part of the offering proceeds to repay its loan to the bank. Further, as the borrower's condition worsened the bank did in fact make additional loans to the borrower to help it maintain its debt and avoid default. As a result, the evidence might have supported the inference that the bank sheltered the borrower from bankruptcy so that the borrower could continue to issue its securities to fund its repayment of its debt to the bank.96

Since the borrower in Metge assumedly violated rule 10b-5 by issuing worthless securities, and since the bank's loans enabled the borrower to continue issuing the securities, the bank's liability depended to a large extent upon the degree of the bank's awareness of its borrower's fraud. The Metge court ultimately classified the bank's role in its borrower's fraud as inaction.97 Consequently, because courts refuse to impose aider and abettor liability on inactive secondary parties absent proof that they actually intended to further the fraud, the investors could only recover from the bank under the aider and abettor doctrine upon their showing that the bank harbored a high degree of conscious intent to aid its borrower's fraud.98

The Metge court's finding that the bank was guilty of mere inaction was pivotal because, had the court classified the bank's role as action, which the facts arguably supported, and had the court been located in a jurisdiction subscribing to the recklessness standard, the investors would have had the much less onerous burden of proving only that the bank acted recklessly.99 Inasmuch as the bank knew that it was keeping its borrower out of insolvency and that the bank therefore knew that the borrower was issuing securities while bordering on bankruptcy, the bank arguably acted recklessly in financing the borrower's fraud. On the other hand, the investor's evidence against the bank obviously fell short of proving the bank's conscious intent

96. Id. at 629.
97. Id. at 624.
98. Id. at 625.
to aid and abet the borrower’s fraud. In short, by classifying the bank’s role as inaction, and therefore imposing upon the investors the unenviably tough burden of proving that the bank intended to facilitate its borrower’s fraud, the Metge court may well have decided the outcome of the case when an alternative classification, accompanied by the investors’ correspondingly lower burden of proving the bank’s mere recklessness, appeared just as plausible.

Brennan v. Midwestern Life Insurance Co.100 further exemplifies the futility of attempting to make a workable distinction between action and inaction. The facts in Brennan indicated that the defendant, Midwestern, failed to inform the state securities board about a fraud that a broker was perpetrating against Midwestern shareholders. The defendant’s failure to disclose the bank’s fraud to its shareholders clearly constituted inaction. While deciding that silence may under certain circumstances, constitute substantial assistance,101 the Brennan court avoided the complications associated with adjudicating an inaction case by emphasizing the fact that Midwestern referred its shareholders who complained of the broker’s conduct directly to the broker himself.102 Midwestern’s referrals of its stockholders to the broker were sporadic, however, and appeared relatively insignificant when compared to the defendant’s prolonged silence.103

If inaction can constitute assistance, then a court may routinely hold a lender liable as an aider and abettor for its mere nondisclosure of information. Such a rule of law could devastate the commercial banking industry.104 Although lenders usually possess an in-depth knowledge of their borrowers’ financial position, a lender’s use of the information would not regularly expose a borrower’s rule 10b-5 violation.

Several facts may explain why courts have not expanded the judicially created aider and abettor doctrine to cover situations involving inaction. First, the language of rule 10b-5 supports the conclusion that neither inac-

---

100. 417 F.2d 147 (7th Cir. 1969), cert. denied, 397 U.S. 989 (1970).
101. 417 F.2d at 154.
102. Id. (characterizing Midwestern’s participation as “affirmative conduct”).
103. A number of courts have rejected the Brennan court’s classification of Midwestern’s assistance as affirmative action. See IIT v. Cornfeld, 619 F.2d 909, 927 (2d Cir. 1980) (“the ‘affirmative action’ in Brennan was slight indeed”); Rochez Bros. v. Rhoades, 527 F.2d 880, 889 (3d Cir. 1975) (referring to Brennan as an inaction case).
104. Courts hold that, especially when the accused aider and abettor merely performs commercial ministerial tasks, imposing liability without proof that the defendant intended the task he performed to further the fraud would be unjust. See Woodward v. Metro Bank, 522 F.2d at 97; Wright v. Schock, 571 F. Supp. 642, 663 (N.D. Cal. 1983); Feldman v. Simkins Indus., Inc., 492 F. Supp. 839, 847 (N.D. Cal. 1980), aff’d, 679 F.2d 1299 (9th Cir. 1982). According to one court, “Knowledge of the underlying violation is a critical element in the proof of aiding-abetting liability, for without this requirement financial institutions... would be virtual insurers of their customers against securities law violations.” Monsen v. Consolidated Dressed Beef Co., 579 F.2d 793, 799 (3d Cir.) (emphasis added), cert. denied, 439 U.S. 930 (1978); see also SEC v. Coffey, 493 F.2d 1304, 1317 (6th Cir. 1974) (where only silence is alleged, too low standard of proof creates a risk of imposing liability upon innocent parties), cert. denied, 420 U.S. 908 (1975). At a minimum, adopting such a policy would drastically increase the costs associated with obtaining financing. Comment, Lender Liability for Security Law Violations of Its Borrowers, 38 OKLA. L. REV. 113, 136-42 (1985).
tion nor silence constitutes assistance. Rule 10b-5, subpart (b) explicitly prohibits silence under certain circumstances.\footnote{Securities Exchange Commission Rule 10b-5, 17 C.F.R. § 240.10b-5 (1986) makes it unlawful 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...” (Emphasis added.)} According to rule 10b-5, however, before such silence violates rule 10b-5 the person must have previously made an affirmative statement that subsequent silence makes misleading.\footnote{Id.} For example, a securities dealer may well violate rule 10b-5 when he emphasizes the recent profitability of an issuer without also disclosing that the issuer’s recent change in inventory valuation methods is at least partially responsible for the attractive results. In other words, rule 10b-5 condemns silence only when it makes a prior affirmative statement misleading.\footnote{See Rudolph v. Arthur Andersen & Co., 800 F.2d 1040, 1043-44 (11th Cir. 1986) (accountant may be subject to duty to disclose ordinary business information pursuant to rule 10b-5 when silence makes a previous report misleading or incorrect); First Va. Bankshares v. Benson, 559 F.2d 1307, 1314 (5th Cir. 1977) (rule 10b-5 only prohibits silence when silence makes prior voluntary statement misleading), cert. denied, 435 U.S. 952 (1978); Wessel v. Buhler, 437 F.2d 279, 284 (9th Cir. 1971) (the only silence rule 10b-5 condemns is that making a prior affirmative statement misleading).} Consequently, even if a lender actually possesses knowledge of a borrower’s fraudulent acts and opts not to inform the victim, the lender’s silence is inaction under rule 10b-5 and accordingly cannot constitute substantial assistance.

Classifying silence or inaction as assistance appears inconsistent with the law underlying aider and abettor liability. Although some forms of aider and abettor liability have been codified, courts originally created the doctrine by analogizing to common law tort and criminal law notions,\footnote{See supra note 33, § 314; see also M. Bassionni, Substantive Criminal Law § 2.2.2 (1978) (absent a statutory or common law duty, there is no criminal liability for mere inaction); 1 W. BURDWICK, THE LAW OF CRIMES § 109 (1946) (same); W. LAFAVE & A. SCOTT, HANDBOOK ON CRIMINAL LAW § 26 (1972) (same); J. TURNER, RUSSEL ON CRIME 402 (1964) (same).} neither of which impose liability for nonfeasance.\footnote{Brennan v. Midwestern United Life Ins. Co., 259 F. Supp. at 680.} Consequently, courts cannot impose liability upon lenders for mere inaction without deviating from those principles that purport to support the doctrine.

The \textit{Woodward} court indicated that the implied cause of action under rule 10b-5 is already overextended and that to expand aider and abettor liability further, to routinely encompass secondary parties, would be inequitable.\footnote{Woodward v. Metro Bank, 522 F.2d at 84. Prior to conceding that Congress probably never intended civil aider and abettor liability to arise from § 10(b), the \textit{Woodward} court noted that: “[t]he very breadth of present 10b-5 law imposes a duty on the courts to evaluate a proposed expansion of the Rule's coverage in light of the facts and circumstances of the new case.” \textit{Id.} at 90. Furthermore, the court disposed of the case without recognizing the existence of rule 10b-5 aiding and abetting liability. Rather, the court held that, if such an action existed, the plaintiff had not carried its burden of proof. \textit{Id.} at 94-95 n.22; accord Wessel v. Buhler, 437 F.2d 279, 283 (9th Cir. 1971) (“exposure of independent accountants and others to such vistas of liability [as created by imposing aider and abettor liability on mere commercial transactions absent a duty], limited only by the ingenuity of investors and their counsel, would lead to serious mischief”).}
Consequently, the Woodward court limited a secondary party's liability for inaction to occasions when the secondary party possessed the highest variety of intent to participate in the fraud.111 Thus, neither rule 10b-5 nor the implied liability thereunder imposes a duty to act when no duty previously existed. Such a result is justified, according to the Woodward court, because "Rule 10b-5 was not designed to be an ethical Ten Commandments for all securities transactions."112

Mostly, courts follow Woodward and hence refuse to impose aiding and abetting liability for failure to act, absent a preexisting legal duty to act or a high degree of conscious intent to perpetrate a fraud.113 This being the case, existing tort principles provide a more equitable framework for adjudicating cases involving fraudulent inaction. If a lender's nondisclosure is actionable because the lender owed the victim a duty of disclosure, courts should base liability on the lender's breach of that duty, rather than on a statutory extrapolation of rule 10b-5. Further, if the lender intentionally fails to act in order to further the fraud, courts may then impose liability on the lender as a principal under theories of conspiracy or agency.114

b. Loans as Assistance

Is a lending institution's loan to a borrower affirmative conduct such that a court can hold that the lender assisted in the fraud that the borrower undertook with the proceeds? Courts have exhibited a willingness to find an affirmative undertaking even when the secondary party's action appeared inconsequential in comparison to its failure to act.115 The courts' propensity for finding action on questionable facts has produced an inconsistent body of case law in which fact finders have free rein to justify their sympathetic reactions with a finding of assistance through active conduct.

A landmark case on the issue of whether loans constitute inaction is Woodward v. Metro Bank.116 In Woodward the evidence indicated that the bank's involvement with the defrauder consisted of lending him money in the ordinary course of business and failing to discover and disclose the defrauder's scheme. The court held that the bank's loan constituted only inaction and, therefore, would not support aider and abettor liability.117

---

111. Woodward v. Metro Bank, 522 F.2d at 95.
112. Id. at 87.
113. Metge v. Baehler, 762 F.2d 621, 625 (8th Cir. 1985); IIT v. Cornfeld, 619 F.2d 909, 925 (2d Cir. 1980); Woodward v. Metro Bank, 522 F.2d at 95.
114. SEC v. Coffey, 493 F.2d 1304, 1316 (6th Cir. 1974); Dasho v. Susquehanna Corp., 380 F.2d 262, 267 n.2 (7th Cir.), cert. denied, 389 U.S. 977 (1967). See generally Gilmore & McBridge, supra note 54, at 813-16 (discusses various theories upon which aiders and abettors may be held as principals); Ruder, supra note 4, at 645-49 (discusses how many failed aiding and abetting actions involve direct duties and may therefore be brought directly on theories of conspiracy or agency).
115. See supra note 103 and accompanying text.
116. 522 F.2d 84 (5th Cir. 1975).
117. Id. at 95; see also Metge v. Baehler, 762 F.2d 621, 625 (8th Cir. 1985) (unless the aider and abettor owes the plaintiff an affirmative duty to disclose information, inaction cannot provide an adequate basis for liability under the substantial assistance analysis).
Monsen v. Consolidated Dressed Beef Co.,\textsuperscript{118} however, and in at least one subsequent decision, courts have treated a lender's extension of credit as an affirmative act tantamount to assistance.\textsuperscript{119} The Monsen court's cursory analysis exemplifies the outcome-oriented nature of these decisions. The Monsen opinion fails to address the underlying policies of aider and abettor liability that should be dispositive of the issue.

Commentators who contend that extending loans in the ordinary course of business, and for legitimate business purposes, can constitute assistance argue that such a classification will further rule 10b-5's goal of protecting investors.\textsuperscript{120} This result is axiomatic. Lenders exposed to potential liability for making loans will of course require potential borrowers to provide more financial information pursuant to each loan and will scrutinize each borrower's business operations more carefully. Such a policy will in effect transform individual lenders into private regulatory agencies. Stepped-up loan approval procedures will reduce the number of frauds perpetrated with loaned funds at the expense of increased transaction costs in a market whose efficiency is essential to the economic well-being of industry and personal finance. Such an effect contravenes Congress's goals of providing for open securities markets without interfering with commercial efficiency.\textsuperscript{121} What is more, the Supreme Court has rejected this private enforcement rationale for creating additional implied causes of actions for securities fraud.\textsuperscript{122}

c. Problems of Causation

General principles of causation offer the most persuasive ground for refusing to extend the current framework of aider and abettor liability to lenders. If courts nevertheless do elect to apply the three-pronged test for aider and abettor liability to lenders, the substantial assistance requirement should import fundamental tort notions of causation.\textsuperscript{123} A causation requirement would guarantee that courts will not routinely burden lenders with the un-

\begin{itemize}
\item \textsuperscript{118} 579 F.2d 793, 799 (3d Cir.), cert. denied, 439 U.S. 930 (1978).
\item \textsuperscript{119} Edwards & Hanly v. Wells Fargo Sec. Clearance Corp., 602 F.2d 478, 484 (2d Cir. 1979) (court perceives extension of loan as action).
\item \textsuperscript{120} Comment, supra note 3, at 241 (arguing that courts should establish a uniform threshold of recklessness for two reasons: (1) recklessness threshold would eliminate the dilemma between action and inaction, and (2) the Supreme Court in Hochfelder slighted the importance of the distinction between primary and secondary liability, thereby indicating that the scienter requirement for each is identical). See generally Note, Liability for Aiding and Abetting Violations of Rule 10b-5: Recklessness Standard in Civil Damage Actions, 62 Tex. L. Rev. 1087 (1985) (arguing that the policies underlying securities law would best be served if courts resolved the existing controversy by adopting a recklessness standard).
\item \textsuperscript{121} For a discussion of the companion purposes of the Securities Exchange Act, see supra note 58.
\item \textsuperscript{122} Jackson Transit Auth. v. Transit Union, 457 U.S. 15, 24 (1981) (legislative history provides conclusive indication of whether a statute creates a cause of action); Cort v. Ash, 422 U.S. 66, 69 (1975) (congressional intention discerned through statutory interpretation, and not a judicial policy of enforcement enhancement, must determine the existence and scope of any course of action).
\item \textsuperscript{123} Rolf v. Blyth, Eastman Dillon & Co., 570 F.2d 38, 48 (2d Cir. 1978) (treating causation as indication of substantiality of assistance), cert. denied, 439 U.S. 1039 (1978). See generally Comment, supra note 3, at 236-38 (arguing that a substantial factor test emphasizes causation should replace the current rule 10b-5 aider and abettor framework).
\end{itemize}
warranted imposition of aider and abettor liability as plaintiffs bring actions based upon more intricate and remote relationships. For example, in a situation in which a defrauder uses loan proceeds to purchase stock in a fraudulent scheme, the lender's extension of credit arguably constitutes a cause in fact or "but for" cause, of the victim's losses. One can say the same for a lender who fails to discover its borrower's fraud based upon the information in the lender's possession.

Courts increasingly emphasize the causal element of the aider and abettor doctrine in order to protect secondary parties from inequitable judgments. Some courts have even required a higher degree of causation akin to proximate cause. The tort law heritage of aider and abettor liability justifies this heightened causal relation requirement. Commentators have even suggested that causation is the touchstone of the aider and abettor issue and, therefore, have advocated the abandonment of the current three-pronged analysis in favor of a substantial factor inquiry. Under general principles of proximate causation a lender never assists its borrower's fraud by extending credit to the borrower in the ordinary course of business and for ostensibly legal purposes. In such a case the lender's inaction cannot be the legal cause of the injury that its borrower inflicts upon the victim. If considered in the context of tort law causation, the relationship between a party who regularly lends funds and a party who borrows funds and uses them for an improper purpose is simply too tenuous to justify joint and several liability upon the lender.

In tort law terms, the criminal intent of the borrower is a supervening cause that the law deems solely responsible for the victim's losses. Some courts have even required a higher degree of causation akin to proximate cause.

---


125. Metge v. Bachler, 762 F.2d 621, 624 (8th Cir. 1985); IIT v. Cornfeld, 619 F.2d 909, 925-26 (2d Cir. 1980) (aider and abettor's assistance must have caused the victim's loss); Edwards & Hanly v. Wells Fargo Sec. Clearance Corp, 602 F.2d 478, 484 (2d Cir. 1979).


128. See W. Prosser & P. Keeton, supra note 124, §§ 43-44; Comment, supra note 3, at 253 ("the trier of fact [should] assess the causal significance of each defendant's conduct; the court cannot ignore the causation question by simply linking the defendant's conduct to a larger scheme").

129. See Comment, supra note 3, at 248-54.

130. In Mendelsohn v. Capital Underwriters, Inc., 490 F. Supp. 1069, 1084 (N.D. Cal. 1979), the court indicated that the alleged aider and abettor did not cause the underlying securities law violation because if it had quit the defrauder's service upon learning of the defrauder's activity, the defrauder would "simply have hired a less astute accountant." Further, although the court did not specifically call it a superseding cause, it held that the defrauder's fraudulent use of the alleged aider and abettor services, and not the services themselves, effected a fraud upon the victims. Id. at 1086. In Edwards & Hanly v. Wells Fargo Sec. Clearance Corp., 602 F.2d at 485, the court generalized that, "if a bank lends money to a customer who then uses it to perpetrate a fraudulent scheme, there is probably neither intent nor causation . . . ."
injuries.131

III. REMEDYING THE AIDER AND ABETTOR DOCTRINE: THE ACTUAL KNOWLEDGE STANDARD

Courts have over-expanded rule 10b-5. The rule's legislative history does not warrant even the recognition of a civil cause of action against primary perpetrators of a rule 10b-5 violation. Nevertheless courts have gone so far as to create a cause of action against parties peripheral to the violation.132 Furthermore, courts have implied the existence of a civil cause of action against secondary parties by analogizing to tort theory.133 The Supreme Court, however, has recently rejected tort as the basis for implying other civil actions arising from violations of securities laws.134 What is more, recent Supreme Court decisions indicate a trend toward restricting the expansion of liability under the Act and interpreting it according to conservative rules of construction.135

One should conclude from the foregoing discussion that if courts do not cut back on existing aider and abettor liability they should at least limit their expansion of the doctrine by requiring plaintiffs to prove that any secondary parties accused of aiding and abetting a rule 10b-5 violation acted with actual knowledge in promoting the fraud. The argument for limited expansion follows because a court's application of the aider and abettor doctrine relieves the plaintiff of proving the elements of common law fraud or a rule 10b-5 violation, and hence emasculates the projections normally afforded a defendant in those actions. As the relationship between the victim and the accused aider and abettor become more remote, the risk of inequitable decisions increases. Courts should adjust the knowledge requirement accordingly.

A. Legislative Intent

The legislative history of section 10(b) clearly indicates that Congress in-

131. RESTATEMENT (SECOND), supra note 33, § 440 defines a superseding cause as "an act of a third person or other force which by its intervention prevents the actor from being liable for harm to another which his antecedent negligence is a substantial factor in bringing about."

Furthermore, the comments to § 440 provide that:

if in looking back from the harm and tracing the sequence of events by which it was produced, it is found that a superseding cause has operated, there is no need of determining whether the actor's antecedent conduct was or was not a substantial factor in bringing about the harm.

Id. § 440 comment b (emphasis added); accord H. HART & A. HONORE, CAUSATION IN THE LAW 129 (1962).

132. See supra note 11 and accompanying text.

133. See supra note 35.

134. See supra note 122 and accompanying text.

135. See Touche Ross & Co. v. Redington, 442 U.S. 560, 577-78 (1979) (Congress's failure to provide for explicit secondary liability in § 17(a) of the Securities Exchange Act of 1934, 15 U.S.C. § 78q(a) (1982), should be construed as affirmatively denying liability similar to that found under § 10(b) and rule 10b-5); Transamerica Mortgage Advisors v. Lewis, 444 U.S. 11, 14 (1979) (broad proscription of fraudulent practices by investment advisors under § 206 of the Investment Advisors Act does not create or alter civil liability; courts must construe remedies available under statutes narrowly).
tended it as a regulatory provision. Courts have created the existing civil remedies under the section. Courts now wrestling with the aider and abettor knowledge requirement might consider the degree to which the section's legislative history does or does not support the aider and abettor cause of action.

The Securities Acts contain provisions that expressly impose civil liability on secondary parties. Notably, in each provision in which Congress has provided for civil liability, Congress also has protected the rights of potential defendants by establishing explicit limitations on the actions and by enumerating adequate defenses. Thus, the statutory structure of the Acts' liability provisions demonstrates that Congress has explicitly provided for liability in those instances deemed appropriate. Courts should interpret section 10(b)'s silence on secondary liability as Congress's affirmative decision to withhold liability on the defrauder's remote cohorts.

The legislative history of section 10(b) provides further indication that Congress consciously restricted the section's scope to the actual defrauder. On several occasions, Congress has refused to amend the section to bring aiders and abettors expressly within its scope. Thus, from a strictly interpretive perspective, section 10(b)'s drafters never intended it to accommodate aiders and abettors.

B. Supreme Court Mandate of Constriction

Courts founded their early decisions recognizing civil liability for aiding and abetting based on a rule 10b-5 violation on the tort theory that the Acts

---

136. For a discussion of the legislative history of § 10(b), see supra note 11 and accompanying text.

137. See supra note 12 and accompanying text.


Securities Act of 1933, § 12(2), 15 U.S.C. § 77l(2) (1982), illustrates Congress's ability to define a specific civil remedy. Section 12(2) provides that any person who is defrauded in any transaction related to the transfer of a security "may sue . . . to recover the consideration paid for such security with interest thereon . . . or for damages . . . ." 15 U.S.C. § 77l(2) (1982).


141. Hearings Before the House Committee on Interstate and Foreign Commerce, 86th Cong., 1st Sess. 93, 103 (1959) (as cited in Fischel, supra note 140, at 98 n.103); see Iroquois Indus. v. Syracuse China Corp., 417 F.2d 963, 966 (2d Cir. 1969) (holding that the meaning of a legislative enactment unbroken by its drafters since its passage should only be altered by congressional action); Gilmore & McBride, supra note 54, at 817 (arguing that Congress's refusal to amend the act to include aiders and abettors is the only indication of the statute's meaning).
created private rights, the violation of which justified private remedies.\textsuperscript{142} The Supreme Court, however, has now discredited the courts' practice of exploiting tort law to imply private remedies based upon the violation of a regulatory provision.\textsuperscript{143} For example, in refusing to recognize a private cause of action for a violation of section 17(e) of the 1934 Act, the Court asserted that a private action only arises if congressional intent, as ascertained through conventional statutory interpretation, mandates recognition of such action.\textsuperscript{144} One can fairly interpret the Supreme Court's recent instruction, therefore, to mean that the relevant inquiry is not whether an implied private action will help protect investors, but rather, whether Congress intended to create such an action.

The courts' creation of the rule 10b-5 action, as it now exists, is the result of courts' ignoring the plain import of the rule's regulatory genesis in order to further what they construed to be the rule's underlying purpose. Such actions conflict with the Supreme Court's mandate against supplementing statutory remedies with newly created private remedies.\textsuperscript{145} The early decisions recognizing civil liability for a violation of rule 10b-5 failed to cite any supportive legislative history for their holdings.\textsuperscript{146} Subsequent decisions affirming and expanding the implied cause of action substituted precedent for statutory support and rationalized their holdings by expounding sweeping generalizations concerning the welfare of investors. The Supreme Court's failure to ratify a private cause of action under rule 10b-5, even when given the opportunity, demonstrates the lack of substantive support for the courts' expansion of rule 10b-5.\textsuperscript{147} Realistically, the Supreme Court is now unlikely to refuse to defer to the mass of precedent supporting the existence of a private right of action under rule 10b-5 generally and the aider and abettor doctrine specifically. The Court would do well, however, to consider the absence of traditional legal justifications for the aider and abettor doctrine and to limit its scope by defining its scienter element as actual knowledge.

C. Availability of More Equitable Remedies

Since other remedies exist that allow plaintiffs to vindicate their rights without compromising either the common law or the statutory protections those areas of law afford defendants, courts should require plaintiffs choosing to bring a private cause of action based on the rule 10b-5 aider and abet-

\begin{itemize}
\item \textsuperscript{142} J.I. Case Co. v. Borak, 377 U.S. 426, 434 (1964) (Court justified private action because it created an additional deterrent effect); Kardon v. National Gypsum Co., 69 F. Supp. 512, 514 (E.D. Pa. 1946) (court expressly ignored statutory interpretation and utilized tort principles).
\item \textsuperscript{143} \textit{See supra} note 135.
\item \textsuperscript{144} Touche Ross & Co. v. Redington, 442 U.S. 560, 568 (1979).
\item \textsuperscript{145} \textit{Id.}
\item \textsuperscript{146} \textit{See} SEC v. Coffey, 493 F.2d 1304, 1319 (6th Cir. 1974); Landy v. FDIC, 486 F.2d 139, 156-59 (3d Cir. 1973); 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).
\item \textsuperscript{147} \textit{See} Ernst & Ernst v. Hochfelder, 425 U.S. 185, 195 (1976). Since the Court in Hochfelder treated the alleged aider and abettor as a principal rather than as an aider and abettor, one commentator argues that the Supreme Court has already implicitly rejected the potential for aiding and abetting liability under rule 10b-5. Fischel, \textit{supra} note 140, at 76.
tor doctrine to prove that the secondary party furthered the primary party's fraud with actual knowledge of the fraud's existence. Any doctrine imposing liability on lenders as aiders and abettors arises as a product of judicial expansion without legislative support, and courts should view it critically. Courts should be especially wary about expanding implied causes of action in the aider and abettor area since other more conventional causes of action are available to protect the rights of investors.

Prior to Congress's enactment of section 10(b), authorizing the SEC to draft rule 10b-5, several remedies for fraud in the market place existed.148 Unfortunately, the inconvenience and complexity of these actions detracted from their attractiveness to plaintiffs. For example, to recover against a secondary party for fraud, a plaintiff must prove that the party engaged in intentionally misleading conduct, that it had the intent to perpetrate a fraud, that the plaintiff acted in reasonable reliance, and that the defendant's conduct caused the plaintiff's damages.149 The elements of a fraud evolved through thousands of judicial decisions. In the area of common law fraud, intense judicial scrutiny has balanced the need to compensate victims against the need to protect defendants who are remotely related to the fraud and are not really responsible for the victim's injuries.150 Elements such as reliance and causation, which the aider and abettor doctrine substantially discards with respect to secondary parties, reduce the risks that a run-of-the-mill transaction, such as making a commercial loan in the ordinary course of business, will entangle the actor in another party's fraud. In fairness, courts should allow these same protections, or their functional equivalents, to defendants in implied actions under federal securities law.

In promulgating the Securities Act of 1933 and the Securities Exchange Act of 1934, Congress supplemented investors' existing common law remedies with well-defined, less cumbersome,151 statutory actions. Through section 12(2) of the 1933 Act, Congress provided investors an explicit civil remedy against sellers employing fraudulent sales schemes.152 In section 11 of the 1933 Act153 Congress provided a civil cause of action, including secondary liability, against sellers filing false registration statements pursuant to

---

148. The most obvious remedy for a defrauded investor is an action for common law deceit. See generally Ruder, supra note 4, at 601-46 (outlining the alternative remedies available to a defrauded investor under common law including fraud, agency, and conspiracy).


150. See W. PROSSER, HANDBOOK OF THE LAW OF TORTS 536-41 (2d ed. 1955) (discussing how courts developed the basis of responsibility in fraud based upon culpability and explaining how scienter requirement serves this purpose).

151. Affiliated Ute Citizens v. United States, 406 U.S. 128, 151 (1972) (rule 10b-5 does not require the same degree of reliance on a misstatement as fraud does); White v. Abrams, 495 F.2d 724, 729 (9th Cir. 1974) (plaintiffs need not go through the rigors of pleading and proving fraud under rule 10b-5 because trend has been for courts to eliminate common law obstacles to recovery).


Further, in section 15 of the 1933 Act, Congress unequivocally created civil liability against controlling persons. Thus, if a lender exerts financial pressure to coerce a borrower into violating federal securities law, Congress has already granted the victim a remedy against the lender. The Acts' civil remedy provisions indicate, however, that when Congress statutorily provided more streamlined federal securities fraud actions to supplement those cumbersome remedies available to defrauded investors at common law, Congress did not intend to eliminate all equitable safeguards that the rigorous common law elements provided. In each instance in which Congress has granted investors a simplified federal securities fraud action it has also compensated potential defendants for the lack of traditional safeguards by enumerating special defenses, granting short limitations periods, and limiting secondary parties' liability.

When courts recognized the aider and abettor doctrine's applicability under rule 10b-5, they further streamlined Congress's already liberal statutory scheme by removing from plaintiffs the necessity of proving many, if not all, of the elements of a primary 10b-5 violation. If an investor brings suit against a lender as a secondary party for common law deceit based on a lender's nondisclosure of information regarding its borrower's fraud, the investor would have to prove all of the elements of a fraud against the lender. If, however, the same investor brings an action against the lender for aiding and abetting its borrower's rule 10b-5 violation, the investor need only provide evidence of the lender's disregard of the risk that its silence would aid its borrower's fraud. If the plaintiff succeeds in shedding any doubt on the lender's mental state, then the lender's nondisclosure appears colored with fraud. Further, since many perceive lenders as deep pockets, a jury may be inclined to label the lender's nondisclosure as substantial assistance regardless of whether the lender was aware of the significance of this nondisclosure of information. Irrespective of the courts' definition of scienter in aider and abettor actions, the aider and abettor doctrine provides significantly fewer checks on a jury's discretion, and therefore, affords defendants fewer safeguards against unsupported jury verdicts then its common law and statutory counterparts.

Although banks do not normally review loan applications with an eye toward fraud, because they do possess a great deal of financial information on their borrowers, they find themselves in a particularly sensitive position should one of their borrowers' commit a fraud against investors. Because a rule 10b-5 aider and abettor action circumvents many of the procedural safeguards existing in more well-defined actions, courts should consider counterbalancing the rights of defendants by defining the required scienter as actual knowledge. Such a rigorous scienter standard would reduce the current disparity between the proof that courts require for the plaintiff to recover under

154. Id.
156. See supra note 139 and accompanying text.
157. See supra note 149 and accompanying text.
158. See supra note 151 and accompanying text.
other common law or statutory remedies and the proof that courts currently require under the aider and abettor doctrine. Plaintiffs may still recover from secondary parties through alternative actions that better protect remote defendants by tempering plaintiffs' sometimes unwarranted zeal with the added burden of proving more comprehensive common law or statutory elements.

IV. Conclusion

Although the Supreme Court has reserved judgment on the issue, aiding and abetting liability in federal securities law is now an undeniable fact. The unsolved issue is to what extent courts will expand or restrict the doctrine's application to more tenuous relationships by defining the defendant's actionable mental state as either knowledge or some lesser state of mind. As plaintiffs urge courts to expand the doctrine to allow actions against secondary parties based upon the inferences that jurors may draw from legitimate commercial relationships, the precise requisite culpability that courts require before allowing recovery becomes critical. A standard that is too low will undoubtedly impose liability when it is not warranted and will, therefore, discourage legitimate productive relationships.

Before expanding the aider and abettor doctrine to burden lenders routinely for the acts of their borrowers by adopting a recklessness standard of culpability, courts should take notice of the action's unconventional evolution and the Supreme Court's recent mandates against implying extra statutory remedies. Such an inquiry produces the following conclusions: first, Congress did not intend section 10(b) to become the genesis of civil liability, much less of aider and abettor liability; second, since tort notions form the basis of the rule 10b-5 aider and abettor doctrine, and since the Supreme Court has discredited such an analogy, the doctrine now has no support; third, the Supreme Court has stated that courts should not imply remedies from statutory provisions when alternative, more equitable, remedies are available. In the case of aider and abettor liability for lenders, the plaintiff has many alternative remedies that may vindicate his rights. These remedies, although more complex, are better designed to accommodate remote or tenuous relationships without creating harsh inequities. If, however, a plaintiff insists on bringing an aider and abettor action based on rule 10b-5, courts should require the plaintiff to prove that the lender involved acted as it did with actual knowledge of its borrower's rule 10b-5 violation.