UNITED STATES DISTRICT COURT
DISTRICT OF RHODE ISLAND

KARLO ASHCHIAN, ROBERT CANDON, CHRISTOPHER COLGAN, DANIEL DESJARLAIS, MICHAEL DESJARLAIS, J. WAYNE DUDLEY, MURRAY EMBREE, MATHEW GOLDMAN, GARY GREENE, OLIVER FORD, JOHN HAMMOND, PATRICIA HAMMOND, CHRIS HARLOW, BRENDON HOARTY, EDWARD M. HOUCK, SUSEN IANNELLA, ARTHUR KALOTKIN, MYRON KAZANJIAN, CAROL NATELSON, SAHAG PETROSIAN, ALVIN SIMS, WILLIAM SEAN RILEY, WILLIAM SIMS, ANTHONY SPICUZZA, FRANK WELLMAN, and MICHAEL WELLMAN	)	C.A. No. 91-0199L[1]
v.	)	
BAY LOAN and INVESTMENT BANK	)	

MEMORANDUM AND ORDER

RONALD R. LAGUEUX, Chief Judge.

This matter is before the Court on objections to two Report and Recommendations issued by Magistrate Judge Boudewyns on January 7, 1993.[2] The first Report and Recommendation

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[1]This Memorandum and Order also applies to six related cases: C.A. No. 91-0240L, C.A. No. 91-0241L, C.A. No. 91-0243L, C.A. No. 91-0245L, C.A. No. 91-0246L, and C.A. No. 91-0247L.

[2]Seven separate cases have been filed based on similar facts and containing identical allegations. In the original, C.A. 91-0199L, 26 individual investors (the "investors") brought suit against Bay Loan and Investment Bank ("Bay Loan"). Bay Loan filed a four-count counterclaim against the individual investors in that case. Subsequently, in the series of six cases set forth in note 1, Bay Loan brought suit against individual investors, who then brought counterclaims against Bay Loan. In these later suits, Bay Loan's complaint alleges the four counts contained in its counterclaim in C.A. No. 91-0199L. Likewise, the investors' counterclaims in the six later cases are identical to the investors' claims in C.A. No. 91-0199L. To minimize confusion,

considered Bay Loan's motion to dismiss the investors' complaint pursuant to Rules 9(b) and 12(b)(6) of the Federal Rules of Civil Procedure. The second Report and Recommendation dealt with the investors' motion to dismiss two counts of Bay Loan's counterclaim pursuant to Rule 12(b)(6). Both sides object to portions of the first Report and Recommendation regarding Bay Loan's motion to dismiss while Bay Loan objects to a portion of the Magistrate Judge's recommendation regarding the investors' motion to dismiss.

BACKGROUND

As Magistrate Judge Boudewyns set forth in the Report and Recommendations, this case revolves around a failed real estate development project in which the investors purchased motel condominium units with money loaned to them, ultimately, by Bay Loan. Between August 1987 and September 1988 Dean Street Development Company and its affiliates ("Dean Street") sold over two hundred motel units as condominiums to various persons, including the investors involved in this case. Upon the purchase of a condominium unit, the investor leased the unit back to Dean Street, which was to manage the motels and use the proceeds to repay the individual investors' mortgages on the condominium units. Dean Street advertised the scheme as "no money down," claiming that the income from the condominiums would cover the

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the Court will avoid referring to the parties as plaintiff and defendant and, using C.A. No. 91-0199L as a base, will refer to the investors' allegations as their "complaint" or "claims" and to Bay Loan's allegations as its "counterclaim."

investors' mortgage payments. To induce the investors to purchase the condominium units, Dean Street provided "offering materials," including appraisals, financial projections, and confidential private placement memoranda, to some of the investors and told some of the others about the contents of these materials.

Importantly, Dean Street also helped arrange the loans for the investors with two mortgage originating corporations, Homeowners Funding Corporation ("Homeowners") and East West Financial Corporation ("East West"). However, these two corporations had asked Bay Loan to finance the condominium purchases and had provided Bay Loan with the "offering materials" regarding the condominium units. Therefore, although the loans to the investors were made in the first instance by Homeowners or East West, Bay Loan, in accordance with a prearranged plan, "purchased" almost all of the condominium loans from the two mortgage originators before the actual closing of the loans. The closing attorney for all loans was George Marderosian, who also represented Dean Street. The monthly mortgage payments on the investors' condominiums were made by Dean Street directly to the mortgage companies, which then dealt with Bay Loan. However, for the 1988 loans, Bay Loan set up a reserve account and accepted a pledge of a certificate of deposit from Dean Street to cover shortfalls and amounts past due on loan payments. Unfortunately, the condominium scheme collapsed, the investors lost their investments, and the payments on the condominium loans remain

largely unpaid.

As indicated in notes 1 and 2 above, a number of suits between the investors and Bay Loan have arisen out of these facts. In all of these suits, the investors allege six basic counts. Essentially, they claim that Bay Loan is liable for: (1) violating state common law rules in its lending activity; (2) aiding and abetting securities fraud in violation of the Section 10(b) of the Securities Exchange Act of 1934 (the "1934 Act"), 15 U.S.C. § 78j(b), and Rule 10b-5, 17 C.F.R. §240.10b-5; (3) conspiracy to violate the 1934 Act; (4) violating state securities law, Mass. Gen. L. ch. 110A; N.H. Rev. Stat. Ann. ch. 421-B; R.I. Gen. Laws ch. 7-11; (5) violating the federal Racketeer Influenced and Corrupt Organizations Act ("RICO"), 18 U.S.C. § 1961 et seq.; and (6) committing common law fraud and deceit. Bay Loan, on the other hand, claims that the investors are liable to it for amounts due on promissory notes, for common law fraud, and for federal securities fraud in violation of the 1934 Act.[3]

Each party challenged the other side's claims for relief. In the first Report and Recommendation that Magistrate Judge Boudewyns issued on January 7, 1993, he recommended that portions of Counts I and VI of the investors' complaint be dismissed, but that the balance of those Counts as well as Counts

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[3]In Count IV of its counterclaim, Bay Loan also alleged that the investors were liable for bank fraud in violation of 18 U.S.C. § 1343. However, Bay Loan has since acknowledged that this count failed to state a valid claim upon which relief could be granted.

II through V not be dismissed. In a second Report and Recommendation issued that day, the Magistrate Judge recommended that Counts III and IV of Bay Loan's counterclaim be dismissed. Both sides now object to a number of the Magistrate Judge's recommendations. The investors argue that no portions of Counts I and VI of their complaint should be dismissed while Bay Loan contends that Counts II through VI of the investors' complaint should be dismissed in their entirety. Additionally, while conceding that Count IV of its counterclaim fails to state a claim upon which relief could be granted, Bay Loan argues that its securities fraud claim in Count III of its counterclaim should not be dismissed.

After hearing oral arguments, the Court took this matter under advisement. The matter is now in order for decision. For the reasons that follow, the Court overrules all objections to the first Report and Recommendation regarding the investors' six claims. However, the Court sustains Bay Loan's objection to the Magistrate Judge's recommendation that Bay Loan's securities fraud claim in Count III of its counterclaim be dismissed.

DISCUSSION

I. Standard of Review

The Court reviews the Magistrate Judge's Report and Recommendation regarding dispositive motions, such as motions to dismiss, de novo. Fed. R. Civ. P. 72(b). To succeed on a motion to dismiss pursuant to Rule 9(b) of the Federal Rules of Civil

Procedure for failure to state a fraud claim with sufficient particularity, the moving party must show that the claims fail to allege the time, place, and content of an alleged false representation. McGinty v. Beranger Volkswagon, Inc., 633 F.2d 226, 228-29 (1st Cir. 1980). To succeed on a motion to dismiss pursuant to Rule 12(b)(6) for failure to state a claim upon which relief can be granted, the moving party must establish that the non-moving party's claims are insufficient as a matter of law. National Credit Union Admin. Bd. v. Regine, 795 F. Supp. 59, 62 (D.R.I. 1992)(citing Harper v. Cserr, 544 F.2d 1121, 1122 (1st Cir. 1976)). In reviewing the sufficiency of the claims, the Court must view all facts and inferences in the light most favorable to the non-moving party and must assume that all of the allegations in the complaint are true. Paradis v. Aetna Casualty & Sur. Co., 796 F. Supp. 59, 61 (D.R.I. 1992). The Court may grant the motion to dismiss only if it is clear from the pleadings that no possible set of facts supporting the non-moving party's claims for relief can be proven. Lopez v. Bulova Watch Co., 582 F. Supp. 755, 767 (D.R.I. 1984).

II. Bay Loan's Motion to Dismiss Investors' Complaint

Magistrate Judge Boudewyns recommended that Bay Loan's motion to dismiss the investors' complaint be granted as to parts of Count I and Count VI, but be denied as to the remainder of the complaint. The investors argue that none of the complaint should be dismissed while Bay Loan contends that the entire complaint, excepting one aspect of Count I, is insufficiently pled and/or

fails to state legally viable claims. After reviewing the arguments, the Court substantially agrees with the Magistrate Judge's recommendations regarding both Bay Loan's 9(b) and 12(b)(6) motions, and finds it necessary to expand on the Magistrate Judge's explanation only in limited areas.

A. Investors' Objections

The investors object to Magistrate Judge Boudewyns's recommendation that the portions of Counts I and VI alleging direct liability should be dismissed. They argue primarily that the Magistrate Judge erred in determining that Bay Loan, which did not have any direct contact with the investors, could not be directly liable to them for negligent misrepresentation or fraud.

The Court agrees that a defendant may be liable for negligent misrepresentation or fraud even in the absence of direct contact or privity. See, e.g., Rusch Factors, Inc. v. Levin, 284 F. Supp. 85, 88-93 (D.R.I. 1968)(accountant, who negligently misrepresented financial stability of a corporation when filling out financial statement for the corporation, was liable for loss plaintiff incurred as a result of loaning money to the corporation, because accountant knew plaintiff would rely on financial statement in deciding whether or not to lend money to the corporation). However, in this case, the facts alleged cannot amount to negligent misrepresentation or fraud.

Essentially, the investors claim that Bay Loan committed misrepresentation and fraud by failing to disclose errors in certain documents in its possession, including titles

to the condominiums, the appraisal of the condominiums, and financial projections for the condominium projects. The investors do not allege that Bay Loan was responsible for writing the allegedly misleading documents. While misrepresentation and fraud can arise from silence as well as false misstatements, Home Loan & Inv. Ass'n v. Paterra, 105 R.I. 763, 768-69, 255 A.2d 165, 168 (R.I. 1969), liability for failure to disclose occurs only when the silent party owes a duty to speak to the injured party. Restatement (Second) of Torts § 551 (1977). Banks, such as Bay Loan, generally deal at arms-length with customers, and thus do not owe their loan customers a duty to disclose. Farmer City State Bank v. Guingrich, 487 N.E.2d 758, 764 (Ill. 1985); Kurth v. Van Horn, 380 N.W.2d 693, 696-698 (Iowa 1986); Denison State Bank v. Madeira, 640 P.2d 1235, 1241 (Kan. 1982). Although such a duty may arise, if the bank is acting as a fiduciary for the customer or has some reason to know that the customer is justifiably relying on the bank for financial advice, see, e.g., Paterra, 105 R.I. at 768-69, 255 A.2d at 168; Macon County Livestock Market, Inc. v. Kentucky State Bank, Inc., 724 S.W.2d 343, 350 (Tenn.App. 1986), the facts alleged by the investors do not suggest that a duty was created in this instance.

Here, the investors do not allege that there was any contact between Bay Loan and the investors, that the investors sought Bay Loan's advice or counsel, or even that the investors knew that Bay Loan was the loan originator at the time of the loans. Thus, the investors fail to allege the existence of a

fiduciary or other special relationship. Absent facts upon which Bay Loan would owe the investors a duty to disclose alleged errors in the documents which Bay Loan had in its possession, the investors' complaint fails to allege claims for negligent misrepresentation or fraud. Accordingly, as the Court also agrees with the Magistrate Judge that the investors have not stated a viable claim in tort or contract for a violation of the duty of good faith between contracting parties, the Court overrules the investors' objections to the Report and Recommendation. The portions of Counts I and VI asserting claims for direct liability against Bay Loan should be dismissed.

B. Bay Loan's Objections

1. Count II - Aiding and Abetting Securities Fraud

Bay Loan's primary argument is that the investors failed to allege that Bay Loan engaged in any conduct which could subject it to securities fraud liability. In Count II, the investors allege that Bay Loan is liable for aiding and abetting the alleged securities fraud which induced the investors to purchase the condominium units. A claim for aiding and abetting a Section 10(b) violation must allege:

> (1) the commission of a violation of § 10(b) or rule 10b-5 by the primary party;
> (2) the defendant's general awareness that his role was part of an overall activity that is improper; and
> (3) knowing and substantial assistance of the primary violation by the defendant.

Cleary v. Perfectune, Inc., 700 F.2d 774, 777 (1st Cir. 1983). For purposes of this motion, Bay Loan contends that the investors failed to plead the third element.

Taking all facts pleaded in the complaint as true, the Court concludes that the investors have alleged that Bay Loan may have provided "knowing and substantial assistance" to Dean Street's alleged securities fraud scheme. Specifically, the investors suggest that Bay Loan provided such assistance directly by issuing loans in an atypical manner while failing to disclose material misrepresentations and omissions in the title policies and the "offering materials," as well as vicariously through the actions of its alleged agents, East West, Homeowners, Marderosian, and Dean Street.

Bay Loan correctly asserts that the mere financing of an investment does not amount to "knowing and substantial assistance." See, e.g., SEC v. Seaboard Corp., 677 F.2d 1315, 1316-17 (9th Cir. 1982)(holding that performance of typical financial services in connection with the sale of securities does not subject bank to liability under the 1934 Act); Seattle-First Nat. Bank v. Carlstedt, 678 F. Supp. 1543, 1549 (W.D.Okla. 1987)(lending money or performing other routine banking services insufficient to create aiding and abetting liability). Importantly, however, "[s]ubstantiality is based upon all the circumstances surrounding the transaction in question," Woods v. Barnett Bank of Ft. Lauderdale, 765 F.2d 1004, 1013 (11th Cir. 1985), and "knowing assistance can be inferred from atypical business actions," id. at 1012; see also American Title Ins. Co. v. East West Fin. Corp., 1993 U.S. Dist. LEXIS 4153, at *31-32 (D.R.I. 1993).

In this case, the investors allege that Bay Loan's participation consisted of more than routine financing, and that such atypical transactions convert the banks actions to knowing and substantial assistance. For instance, the investors contend that Bay Loan knew of errors in documents on which Bay Loan realized the investors would rely, that Bay Loan designed unique unwritten underwriting rules to ease restrictions for granting loans for the condominium units, and that Bay Loan created a special reserve account for Dean Street with a substantial portion of the loan proceeds. The investors allege that these and other business actions in which Bay Loan engaged in support of the motel/condominium projects were atypical. Although the investors may have difficulty ultimately proving that Bay Loan knowingly and substantially assisted the condominium securities fraud,[4] the Court will not decide as a matter of law that the investors have not adequately alleged such assistance at this stage of the proceedings.

Further, the investors claim that Bay Loan is vicariously liable for the alleged aiding and abetting engaged in by Bay Loan's alleged agents, East West, Homeowners, Marderosian,

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[4]After a bench trial in a related case in which American Title Insurance Company, the company which insured the majority of the titles to the condominiums, sued Bay Loan and East West, Judge Torres concluded that Bay Loan had not aided and abetted in a securities fraud. American Title Ins. Co., 1993 U.S. Dist. LEXIS 4153, at *29-32. In fact, he noted that, because Bay Loan had placed so much money at risk by issuing loans secured by the condominium projects, it would be "patently unreasonable" to conclude that Bay Loan knowingly engaged in a fraud involving the condominiums. Id. at *32.

and Dean Street. Federal securities law incorporates common law agency concepts of respondeat superior, and, thus, principals may be liable for securities law violations committed by their agents. See In re Atlantic Fin. Management, Inc., 784 F.2d 29, 35 (1st Cir. 1986)(corporation may be held vicariously liable under Section 10(b) of the 1934 Act and Rule 10b-5 for agent's misrepresentations), cert. denied sub nom. AZL Resources, Inc. v. Margaret Hall Found., Inc., 481 U.S. 1072, 107 S.Ct. 2469, 95 L.Ed.2d 877 (1987); see also Commerford v. Olson, 794 F.2d 1319, 1322-23 (8th Cir. 1986)(federal securities law does not preempt common law agency principles as a basis for recovery); Marbury Management, Inc. v. Kohn, 629 F.2d 705, 716 (2d Cir. 1980)(respondeat superior principles apply in Section 10(b) securities fraud case), cert. denied sub nom. Wood Walker & Co. v. Marbury Management, Inc., 449 U.S. 1011, 101 S.Ct. 566, 66 L.Ed.2d 469 (1980). A principal can be vicariously liable for Section 10(b) aiding and abetting if its agents aid and abet a securities fraud. See, e.g., Barnett Bank of Ft. Lauderdale, 765 F.2d at 1013 n.15 (Barnett Bank liable for aiding and abetting based on the actions of its employee).

Bay Loan argues that the investors failed to allege that Marderosian and Dean Street were Bay Loan's agents. In order for an agency relationship to exist, three components must co-exist: (1) a manifestation by the principal that the agent will act for him, (2) an acceptance by the agent of the undertaking, and (3) an agreement between the parties that the

principal will be in control of the undertaking. Focus Inv. Assoc., Inc. v. American Title Insurance Co., 797 F. Supp. 109, 112 (D.R.I. 1992), aff'd in part & vacated in part on other grounds, 1993 U.S. App. LEXIS 10904 (1st Cir. 1993); Restatement (Second) of Agency § 1(1) (1958). Although the investors do not carefully detail the facts that would render Marderosian or Dean Street agents of Bay Loan, the complaint in its entirety contains sufficient facts from which agency relationships could be inferred. Additionally, the investors allege that Bay Loan's agents provided knowing and substantial assistance to the condominium securities fraud scheme. For instance, the complaint alleges that Marderosian issued inaccurate title policies and made other misrepresentations while it states that Dean Street utilized appraisals, financial projections, and other documents containing material misrepresentations and omissions. Therefore, for purposes of this motion, the investors have also sufficiently pleaded that Bay Loan is vicariously liable for the alleged aiding and abetting conduct of its alleged agents.

2. Counts III - V

The Court next turns briefly to Bay Loan's objections to the Report and Recommendation's conclusions regarding Counts III through V. First, in opposing the Magistrate Judge's recommendations on Counts III and V, Bay Loan relies heavily on its arguments that the investors failed to allege aiding and abetting. As the Court has already discussed its reasons for rejecting such theories, further explanation is unnecessary to

overrule Bay Loan's 12(b)(6) objections as to Counts III and V. Likewise, the Court overrules Bay Loan's objection to the Report and Recommendation's conclusion regarding the investors' state securities law claims in Count IV. While the Court agrees with the Magistrate Judge that the investors may face difficulty proving that Bay Loan directly or indirectly controlled a seller of securities, it concludes that the investors have stated adequate facts at the pleading stage from which a factfinder could infer that Bay Loan had such control. Finally, concluding that the claims are otherwise sufficiently pleaded, the Court also adopts, without further discussion, Magistrate Judge Boudewyns's recommendations regarding Bay Loan's 9(b) claims.

III. Investors' Motion To Dismiss Bay Loan's Counterclaim

In the second Report and Recommendation Magistrate Judge Boudewyns issued on January 7, 1993, he recommended the dismissal of Count III of Bay Loan's counterclaim. In Count III of its counterclaim, Bay Loan asserts that the individual investors violated Section 10(b) of the 1934 Act and Rule 10b-5, promulgated by the Securities Exchange Commission thereunder. Specifically, Bay Loan alleges that the investors induced the bank to issue loans to them by misrepresenting material facts in connection with their pledges of condominium securities as collateral for said loans. Bay Loan alleges that on their loan documents the investors misrepresented the amount of down payments they had paid on their respective condominium units as well as their respective individual net worths. Such

misrepresentations, Bay Loan contends, misled Bay Loan about the true purchase price of the securities, the proportion of equity the investors had in the securities, and the value of the securities. Bay Loan further asserts that it would not have issued the loans if it had known the truth regarding the securities, that it suffered monetary losses as a result of the loans, and that the investors are civilly liable to Bay Loan for these losses.

Section 10(b) was "meant to bar deceptive devices and contrivances in the purchase or sale of securities whether conducted in the organized markets or face to face." Superintendent of Ins. v. Bankers Life & Casualty Co., 404 U.S. 6, 12, 92 S.Ct. 165, 169, 30 L.Ed.2d 128 (1971). Accordingly, in order for a private party to have standing under Section 10(b) and Rule 10b-5, the claim must at least allege that the party suffered harm in connection with the purchase or sale of a security. 15 U.S.C. 78j(b); 17 C.F.R. § 240.10b-5; Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 95 S.Ct. 1917, 44 L.Ed.2d 539 (1975). In the present case, Magistrate Judge Boudewyns concluded that Bay Loan had no standing to bring the securities fraud claim alleged in Count III of its counterclaim because it neither purchased nor sold the condominium securities. Therefore, he recommended that Bay Loan's Count III be dismissed. The investors' urge the Court to adopt the Magistrate Judge's conclusions. At the hearing, the investors also argued that, even if Bay Loan were considered a purchaser, the alleged

misrepresentations about which Bay Loan complains were not made "in connection with" Bay Loan's purchase of the condominium securities. Nonetheless, as explained below, the Court concludes that Bay Loan sufficiently pleaded a securities fraud claim in Count III of its counterclaim, and, therefore, sustains Bay Loan's objection to the Magistrate Judge's recommendation.

A. Pledgee as "Purchaser" Under Section 10(b) and Rule 10b-5

Bay Loan alleges that the investors misrepresented material facts regarding the securities they pledged to Bay Loan as collateral for loans. Bay Loan argues that it acquired standing as a "purchaser" under the 1934 Act from its role as pledgee bank. As explained below, the Court agrees with Bay Loan that the pledge of a security as collateral for a loan can constitute a sale for purposes of the 1934 Act, and that Bay Loan was a "purchaser" of the condominium securities.

In 1981, the Supreme Court ruled that a pledge of stock to a bank as collateral for a loan qualified as an "offer" or "sale" of the security under § 17(a) of the Securities Act of 1933 ("1933 Act"), 15 U.S.C. § 77q(a). Rubin v. United States, 449 U.S. 424, 429-430, 101 S.Ct. 698, 701, 66 L.Ed.2d 633 (1981). Although Rubin involved a criminal case under the 1933 Act, just a year later the Supreme Court announced a similar conclusion in a case governed by the 1934 Act. Marine Bank v. Weaver, 455 U.S. 551, 554 n.2, 102 S.Ct. 1220, 1222 n.2, 71 L.Ed.2d 409 (1982). In Weaver, the Court noted:

> The Court of Appeals also concluded that the pledge of a security is a sale, an issue on which the Federal

> Circuits were split. We held in Rubin v. United States, 449 U.S. 424, 101 S.Ct. 698, 66 L.Ed.2d 633 (1981), that a pledge of stock is equivalent to a sale for the purposes of the antifraud provisions of the federal securities laws. Accordingly, in determining whether fraud may have occurred here "in connection with the purchase or sale of any security," the only issue now before the Court is whether a security was involved.

Id. (emphasis in original).

As the investors point out, because the Court in Weaver ultimately determined that the pledged certificate of deposit was not a security, this footnote is dictum. However, circuit courts ruling on the issue after Rubin and Weaver have repeatedly held that a pledge of a security is a sale under both the 1933 Act and the 1934 Act. See, e.g., Haralson v. E.F. Hutton Group, Inc., 919 F.2d 1014, 1032 (5th Cir. 1990), modified on other grounds, 1991 U.S. App. LEXIS 1029 (5th Cir. 1991); Angelastro v. Prudential-Bache Sec., Inc., 764 F.2d 939, 945 n.9 (3d Cir.), cert. denied, 474 U.S. 935, 106 S.Ct. 267, 88 L.Ed.2d 274 (1985); Head v. Head, 759 F.2d 1172, 1174-75 (4th Cir. 1985); Abrams v. Oppenheimer Gov't Sec., Inc., 737 F.2d 582, 587 (7th Cir. 1984); Chemical Bank v. Arthur Andersen & Co., 726 F.2d 930, 939-940 (2d Cir.), cert. denied, 469 U.S. 884, 105 S.Ct. 253, 83 L.Ed.2d 190 (1984); see also VIII Louis Loss & Joel Seligman, Securities Regulation 3712 (3d ed. 1991)("Quite clearly a pledgor is a "seller" and a pledgee is a "purchaser"); Thomas Lee Hazen, The Law of Securities Regulation, § 13.3 (1984)("A pledge of securities generally is held to be a sale under the [1934] Act and accordingly the pledgees are "purchasers" and able to

maintain a rule 10b-5 cause of action . . . "). Importantly, the cases on which the investors rely, see, e.g., Lincoln National Bank v. Herber, 604 F.2d 1038 (7th Cir. 1979); National Bank of Commerce v. All American Assur. Co., 583 F.2d 1295 (5th Cir. 1978); Reid v. Hughes, 578 F.2d 634 (5th Cir. 1978), were all decided prior to Rubin and Weaver, when, as the Weaver Court noted, the circuits were still split on the issue of whether a pledge of a security was a sale.

Despite the numerous cases adopting the Weaver view, the investors argue that, since the Weaver footnote is dictum and the First Circuit has not addressed the issue, this Court is free to determine that a pledge is a not sale under the 1934 Act. The investors note that the definitions of "sale" or "sell" are different in the two acts.[5] They explain that in Rubin the Supreme Court relied on language in the 1933 Act definition of "sale" that is absent from the 1934 Act definition. The investors emphasize that the Rubin Court held, "Although pledges transfer less than absolute title, the interest thus transferred is an 'interest in a security.'. . . It is not essential under

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[5]The 1933 Act provides:

> The term "sale" or "sell" shall include every contract of sale or disposition of a security or interest in a security, for value. The term "offer to sell", "offer for sale", or "offer" shall include every attempt or offer to dispose of, or solicitation of an offer to buy, a security or interest in a security, for value. . . .

15 U.S.C. § 77b(3). The 1934 Act, on the other hand, simply states:

> The terms "sale" or "sell" each include any contract to sell or otherwise dispose of.

15 U.S.C. § 78c(14).

the terms of the [1933] Act that full title pass to a transferee for the transaction to be an 'offer' or a 'sale.'" Rubin, 449 U.S. at 429-30, 101 S.Ct. at 701. They note that, while the 1933 Act dictates that the disposition of an "interest in a security" constitutes a sale, the 1934 Act definition provides no parallel.

The investors' theory is not novel; as they concede, the Second Circuit has already specifically addressed and rejected similar arguments.[6] Chemical Bank, 726 F.2d at 939-40 & n.17. The investors fail to convince this Court that the Second Circuit's analysis of the definition of sale in the 1934 Act was erroneous, or, for that matter, that the numerous courts which, subsequent to Rubin and Weaver, have determined that a pledge could be a sale for purposes of the 1934 Act were wrong.

B. Fraud "In Connection With" Purchase of Securities

The investors also argue that the misrepresentations about which Bay Loan complains did not concern the securities, but rather involved the investors' financial condition. They point to the Second Circuit's analysis in Chemical Bank, 726 F.2d at 941-45. In that case, the plaintiff banks had loaned money to a corporation, accepting pledges of stock in the corporation's wholly owned subsidiary as collateral for the loans. Id. at 941.

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[6]Additional authorities also support the propriety of looking to the definition of sale in the 1933 Act in construing that term in the 1934 Act context. See, e.g., Lawrence v. SEC, 398 F.2d 276, 280 (1st Cir. 1968)("We see no reason to believe that Congress intended, one year after the passage of the Securities Act, to dilute the concept of 'sale' in the Securities Exchange Act"); see also VIII Loss & Seligman, at 2420, 2420-22 n.191 & 3702.

After the loan was issued, but before it was repaid, both the corporation and its subsidiary ceased operations. The banks brought a Section 10(b) securities fraud suit, claiming that they had issued the loan to the parent corporation, and "purchased" the subsidiary corporation stock as a pledge for that loan, in reliance on misrepresentations in the financial statements of the parent corporation. Id. They argued that the misrepresentations regarding the parent corporation affected their purchase of stock because, since the parent corporation's finances were weaker than the financial statements indicated, the banks would have to rely more heavily on the pledged stock. Id. The Second Circuit, however, rejected the banks' analysis. The Court reasoned that the buyers were not deceived about the value of the securities they purchased, and thus the misrepresentations were not made "in connection with" the purchase of the securities. Id. at 941-45.

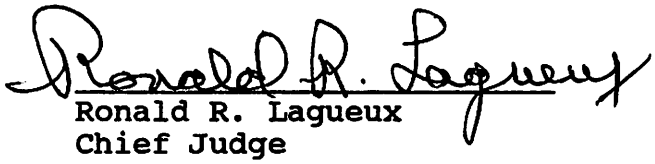
The investors contend that a similar analysis precludes Bay Loan's claim in this case. The Court agrees that the alleged fraud must have been "in connection with" the purchase or sale of the securities. See Superintendent of Ins., 404 U.S. at 12-13, 92 S.Ct. at 169. However, the Court disagrees with the investors' position. Although the investors characterize Bay Loan's allegations as only concerning the investors' financial conditions, Bay Loan has asserted that the investors misled Bay Loan about the true purchase price of the securities, the proportion of equity the investors had in the securities, and the value of the securities. Thus, Bay Loan has sufficiently alleged

a securities fraud claim in Count III of its counterclaim.

CONCLUSION

For the reasons stated above, the Court adopts the Magistrate Judge's recommendations regarding the investors' claims. The Court therefore overrules the investors' objections to the Magistrate Judge's first Report and Recommendation recommending dismissal of portions of Counts I and VI, and grants Bay Loan's motion to dismiss as to portions of Counts I and VI. Similarly, the Court also overrules Bay Loan's objections to the recommendation that portions of Counts I and VI and all of Counts II through V not be dismissed, and denies Bay Loan's motions pursuant to Rules 9(b) and 12(b)(6) on these Counts. However, the Court sustains Bay Loan's objection to the Magistrate Judge's second Report and Recommendation recommending dismissal of Count III of Bay Loan's counterclaim, and therefore denies the investors' motion to dismiss as to that securities fraud claim.

It is so Ordered.



Ronald R. Lagueux
Chief Judge
May 25, 1993