PLAINTIFF'S WRONGFUL CONDUCT AS A BAR TO RECOVERY UNDER REGULATION U

Serzysko v. Chase Manhattan Bank, 290 F. Supp. 74 (S.D.N.Y. 1968)

Edward Serzysko borrowed money from the Chase Manhattan Bank through loans secured primarily by registered securities.[1] In obtaining the loans, he knowingly and intentionally deceived the bank by stating that the money was not to be used for the purchase of registered securities. When the stock market declined, the bank sold the stock and applied the proceeds to Serzysko's debt. In suing for damages, Serzysko alleged that the loans violated Regulation U.[2] This regulation, promulgated pursuant to Section 7(a) of the Securities Exchange Act of 1934,[3] provides that no bank can grant a loan for the purpose of purchasing registered securities when the loan is secured by stock and exceeds the maximum loan value of the stock.[4] The bank responded to the plaintiff's suit by filing a counterclaim for the unpaid balance of the loan. *Held:* Serzysko, an experienced investor familiar with the provisions of Regulation U, could not mislead the bank into making loans which violated Regulation U and then recover on the ground that the bank was negligent in making the loans to him. The Chase Manhattan Bank, by reason of its failure to accept the plaintiff's statements in good faith as defined in Regulation U,[5] could not recover the amount due on the loan.

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1 Registered securities are "issues of stock which are registered on a national securities exchange." Serzysko v. Chase Manhattan Bank, 290 F. Supp. 74, 76 (S.D.N.Y. 1968).

2 12 C.F.R. § 221 (1969). In effect, Serzysko's request for damages was no more than an action for recission on the grounds of illegality. If his obligation under the loan contract was rescinded, then the bank would be liable for the shares of stock sold. Serzysko v. Chase Manhattan Bank, 290 F. Supp. 74, 88 (S.D.N.Y. 1968).

3 15 U.S.C. § 78g (Supp. IV, 1969).

4 "No bank shall extend any credit secured directly or indirectly by any stock for the purpose of purchasing or carrying any stock registered on a national securities exchange . . . in an amount exceeding the maximum loan value of the collateral. . . ." 12 C.F.R. § 221.1 (1969) (footnotes omitted). Maximum loan value is sometimes referred to as the minimum margin requirement. Serzysko v. Chase Manhattan Bank, 290 F. Supp. 74, 77 (S.D.N.Y. 1968). The maximum loan value is the percentage of current market value at which the lender is required to value registered securities. 12 C.F.R. § 221.4 (1969); L. Loss, SECURITIES REGULATION 1244 (1961). In Serzysko the plaintiff's loan exceeded the maximum loan value of the securities. Serzysko v. Chase Manhatten Bank, 290 F. Supp. 74, 81-82 (S.D.N.Y. 1968).

5 The lender can rely on the statements of the borrower regarding the purpose of the loan if accepted in good faith. "To accept the customer's statement in good faith, the officer must (1) be alert to the circumstances surrounding the credit and (2) if he has any information which would cause a prudent man not to accept the statement without inquiry, have investigated and be satisfied that the customer's statement is truthful." 12 C.F.R. § 221.3(a) (1969).

In disposing of plaintiff's claim, the court begins with the premise that implied private actions are available to investor-borrowers against lenders who violate Regulation U.[6] The court then considers the nature of the action to determine whether the plaintiff, by intentionally deceiving the defendant, forfeited his right of recovery.[7] In the leading case of *Remar v. Clayton Securities Corporation*, the implied remedy was considered an action in tort.[8] Since the *Remar* court based the tort action on § 286 of the Restatement, it can be argued that the defenses created by § 286(d) should apply.[9] Under § 286(d), the plaintiff is barred from recovery if he "has so conducted himself as to disable himself from maintaining an action." The *Serzysko* court reasons that § 286(d) must be read in the light of the Supreme Court case of *J.I. Case v. Borak*.[10] In *Borak*, the Court held that a civil remedy was to be implied for violation of Section 14 of the Securities Exchange Act since the creation of such an action would further the legislative purpose behind the statute.[11] The *Serzysko* court, then, argues that the limitation imposed by § 286(d) should only be available if, by applying it, the legislative purpose of the statute involved would be furthered. Since legislative purpose, not the common law of remedies, is controlling, the court rejects Chase Manhattan's suggestion that the doctrine of *in pari delicto* should bar the plaintiff's recovery.[12] To buttress this conclusion, the *Serzysko* court quotes from the Supreme Court's discussion of *in*

6. The Securities Exchange Act does not provide a private cause of action for a violation of the margin requirements. Nevertheless the courts have consistently implied private actions for such violations. Serzysko v. Chase Manhattan Bank, 290 F. Supp. 74, 78 (S.D.N.Y. 1968) and cases cited; Note, 66 COLUM. L. REV. 1462 (1966).

7. Despite arguments that the implied action was not meant to cover experienced investors like Serzysko, the court held that the matter of his experience should determine his right to recover, not his right to sue. Serzysko v. Chase Manhattan Bank, 290 F. Supp. 74, 87 (S.D.N.Y. 1968).

8. 81 F. Supp. 1014, 1017 (D. Mass. 1949).

9. The *Remar* court specifically uses this provision. *Id.* RESTATEMENT OF TORTS § 286 (1934) provides as follows:

> The violation of a legislative enactment by doing a prohibited act, or by failing to do a required act, makes the actor liable for an invasion of an interest of another if:
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> (a) the intent of the enactment is exclusively or in part to protect an interest of the other as an individual; and
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> (b) the interest invaded is one which the enactment is intended to protect; and,
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> (c) where the enactment is intended to protect an interest from a particular hazard, the invasion of the interests results from the hazard; and,
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> (d) the violation is a legal cause of the invasion, and the other has not so conducted himself as to disable himself from maintaining an action.

10. 377 U.S. 426 (1964).

11. *Id.* at 433-34.

12. Serzysko v. Chase Manhattan Bank, 290 F. Supp. 74, 88-89 (S.D.N.Y. 1968).

pari delicto in *Perma Life Mufflers, Inc. v. International Parts Corporation.*[13] The court then concludes by reasoning that allowing recovery would encourage deception of lenders by investor-borrowers and increase the amount of illegal credit in the market.[14] Thus, despite their rejection of the *in pari delicto* defense, and despite the negligence of Chase Manhattan, the court denies Serzysko relief on the basis of his own conduct.

In determining the defendant's counterclaim, the court reasoned that since the bank was negligent in not discovering the falsity of the plaintiff's statements, and since such negligence was prohibited by statute, it was barred from relief by its own conduct.[15]

Traditionally, the words *"in pari delicto"* mean "in equal fault."[16] The doctrine is used in tort to bar contribution among joint tortfeasors,[17] and in contract to deny any type of affirmative relief to one breaching party against another.[18] The general rule is that when parties are in equal fault, or *in pari delicto,* no relief is given either party unless public policy demands otherwise.[19]

In *Perma Life Mufflers, Inc. v. International Parts Corporation,*[20] the Supreme Court held that the public policy behind private anti-trust actions made the defense of *in pari delicto* unavailable when the plaintiff's participation in the illegal arrangement "was not voluntary in any meaningful sense."[21] Justice Black, writing the opinion of the Court, flatly rejected the doctrine of *in pari delicto.* The plaintiff's remedy, Justice Black reasoned, was expressly granted to him for the purpose of aiding the government in enforcing the anti-trust laws. This purpose should not be frustrated by denying relief on the basis of an implied defense.[22]

It should be noted, however, that Justice Black wrote only for himself and three other justices. The other five justices recognized the defense of *in pari delicto* or some modified version of it. Mr. Justice

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13 392 U.S. 134 (1968).

14 Serzysko v. Chase Manhattan Bank, 290 F. Supp. 74, 89-90 (S.D.N.Y. 1968).

15 *Id* at 90

16. BLACK'S LAW DICTIONARY 898 (4th ed. 1951).

17 *See* W. PROSSER, HANDBOOK OF THE LAW OF TORTS 273-78 (3d ed. 1964).

18 *Cf.* Ryan v. Motor Credit Co., 130 N.J. Eq. 531, 23 A.2d 607 (Ch. N.J. 1941).

19 *See e.g., Id.; cf.* Jackson v. Associated Dry Goods Corp., 13 N.Y.2d 112, 192 N.E.2d 167, 242 N.Y.S.2d 210 (1963); Ohio Fuel Gas Co. v. Pace Excavating Co., 91 Ohio L. Abs. 184, 187 N.E.2d 89 (Ohio Ct. App. 1963).

20 392 U.S. 134 (1968).

21. *Id* at 139.

22 *Id* at 138-39.

White, for example, conceded that *in pari delicto* cannot be used to frustrate legislative purpose. Nonetheless, he would have applied a test denying recovery "where plaintiff and defendant bear substantially equal responsibility for injury resulting to one of them but permit[ting] recovery in favor of the one less responsible where one is more responsible than the other."[23]

The remedy in *Perma* was expressly created by statute; that in *Serzysko* is implied. Nevertheless, there are similar policies behind their creations. The anti-trust treble damages for which the plaintiff in *Perma* brought action was meant to serve both as a threat to violators and as an incentive for injured individuals to bring violations to light by private action.[24] *Borak* and the line of implied liability cases following it use the same policy arguments to justify civil recovery in the absence of express statutory authority.[25] Since the policies behind congressionally imposed anti-trust damages and judicially implied liability under the Securities Exchange Act are the same, and since five justices of the Supreme Court felt that at least a modified form of *in pari delicto* should serve as a defense to antitrust actions based on an express remedy, the way is clear for the courts to allow a similar defense to implied recovery under Regulation U.[26]

The *Serzysko* court allowed the plaintiff's actions to bar his

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23. *Id.* at 146. Mr. Justice Fortas, concurring, would ask if "the fault of the parties is reasonably within the same scale." *Id.* at 147. Mr. Justice Marshall, also concurring, would "hold that where a defendant . . . can show that the plaintiff actively participated in the formation and implementation of an illegal scheme, and is substantially equally at fault, the plaintiff should be barred from imposing liability." *Id.* at 149. Justices Harlan and Stewart concur and dissent in part. They would bar recovery by "(p)laintiffs who . . . have themselves violated the law in cooperation with the defendant." *Id.* at 153.

24. *Id.* at 138-39.

25. J.I. Case Co. v. Borak, 377 U.S. 426, 432-33 (1964); Globus v. Law Research Inc., CCH FED. SEC. LAW REP., C. ¶ 92,374 at p. 98242-43 (2d Cir. 1969).

26. *Cf.* Flusk v. Erie R.R., 110 F. Supp. 118 (D.N.J. 1953). The case involved a railroad employee's action against the railroad under the Federal Employer's Liability Act, and against a shipper under common law, for injuries sustained during loading operations. The court held that a finding of contributory negligence on the part of the employee would have barred his action against the shipper, but would have acted only as a proportionate diminishing factor in any verdict against the railroad. In a similar case involving the Jones Act, the court held that the defendant employer could use neither assumption of risk nor contributory negligence as a complete defense; nevertheless, the third-party defendant shipyards, not subject to the Jones Act, could use both. Ginsburg v. Standard Oil Co., 5 F.R.D. 48 (S.D.N.Y. 1945). These cases suggest that courts are willing to go farther in granting relief to a plaintiff bringing an action under a regulatory statute than to a plaintiff bringing an action under common law. Thus, courts would probably go farther in granting relief to a plaintiff in an action under civil antitrust law than to a plaintiff in an implied action under Regulation U.

recovery. But it ignores or rejects the kind of modified *in pari delicto* defenses proposed by the concurring and dissenting Justices in *Perma* without articulating any standard to take their place. By basing its denial of relief strictly on policy, and by failing to indicate the factors which might determine the applicability of its decision in future litigation, the court exposes itself to criticism.

Though the *Serzysko* court reasons that the legislative purpose behind Regulation U will not be furthered if recovery is allowed to plaintiffs who intentionally deceive lenders, it ignores the possibility that allowing such recovery might encourage bankers to comply with the Act. If, despite the intention of the borrower, bankers were held liable because of their negligence, they would, arguably, be more careful in extending credit. This would mean that the amount of credit in the market would be more carefully controlled.[27] In support of this argument, it should be noted that Congress did not prohibit a borrower from wilfully seeking credit in violation of the act.[28] Imposing uncompromising liability on a bank which negligently violates Regulation U, then, would seem at least as consistent with furthering legislative purpose as the holding of the *Serzysko* court.[29] The court, however, assumes that under such a system the bank would be acting as an insurer for a plaintiff who intentionally deceives them. But if the bank can show that it has made a reasonable investigation they have an absolute defense.[30]

The court's failure to articulate the standard it applies to bar Serzysko's recovery creates a further problem. If the court's ruling is broadly read, it will discourage investor borrowers from bringing damage actions under Regulation U.[31] This would frustrate the judicial policy which allows individuals to bring violations to light by private damage suits. Many investors have at least some knowledge of

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27 *See* Note, 66 COLUM. L. REV. 1462, 1475 (1966).

28 Serzysko v. Chase Manhattan Bank, 290 F. Supp. 74, 89 (S.D.N.Y. 1968).

29 *Cf.* Kuehnert v. Texstar Corp., 412 F.2d 700, 705 (5th Cir. 1969) (dissent); Wade, *Benefits Obtained Under Illegal Transactions - Reasons For and Against Allowing Restitution*, 25 TEXAS L. REV. 31, 55-56 (1946).

30 12 C.F.R. § 221.3 (1969).

31 The court asserts that the "knowing and intentional making of a false statement is fraught with prejudice" to enforcement of the regulation. Serzysko v. Chase Manhattan Bank, 290 F. Supp. 74, 89 (S.D.N.Y. 1968). They also point to Moscarelli v. Stamm, 288 F. Supp. 453 (E.D.N.Y. 1968) in which the plaintiff's willful participation in a margin requirement violation was held to bar his subsequent recovery under Regulation T. Nonetheless the court holds only that the defendant "by reason of his conduct, should be denied relief. . . ." Serzysko v. Chase Manhattan Bank, 290 F. Supp. 74, 90 (S.D.N.Y. 1968).

Regulation U. In any event, at the time of the loan the borrower who pledges securities signs a purpose statement.[32] He deliberately deceives the lender if he intends to purchase securities but states that the loan is for another purpose. Since all borrowers who use registered securities as collateral for bank loans must sign such a statement,[33] nearly any person bringing action under Regulation U can be found to have intentionally deceived the lender. If intentional deceit is a nearly absolute bar to suit, as could be implied from the *Serzysko* court's opinion,[34] then suits for recovery would be virtually impossible to sustain.

By articulating a standard which could relate to other fact situations, rather than deriving a holding from the broad basis of enforcement policy without identifying the specific factors it considered controlling, the court could have avoided the criticisms just noted. The equal responsibility standard purposed by Justice White in *Perma* offers at least a guide to the kind of test which should have been applied.[35]

Under the equal responsibility test, the bank could not avoid liability by merely pointing to its deception by the borrower. To bar a recovery, its own negligent conduct would have to be less blameworthy than that of the borrowers.[36] On the other hand, wilful deception would not be encouraged since a borrower's calculated deception might overshadow the defendant's mere negligence. This balancing approach harmonizes with the purposes behind implied remedies. It is submitted that the kind of flexible standard articulated by Justice White in *Perma* should be applied in the context of Regulation U

32. 12 C.F.R. § 221.3 (1969).

33. *Id.*

34. *See* note 31, *supra.*

35. This sort of weighing of liabilities has worked well in other contexts. In tort, the party whose negligence has been passive may have contribution from an active tortfeasor. *See, e.g.,* Jackson v. Associated Dry Goods Corp., 13 N.Y.2d 112, 192 N.E.2d 167, 242 N.Y.S.2d 210 (1963); Ohio Fuel Gas Co. v. Pace Excavating Co., 91 Ohio. L. Abs. 184, 187 N.E.2d 89 (Ohio Ct. App. 1963). Since the burden of compliance is on the banker, one could draw analogies to situations in which a party who is under secondary liability is allowed to recover from another who is under primary liability. *See. e.g.,* City & County of San Francisco v. Ho Sing, 51 Cal.2d 127, 330 P.2d 802 (1958); Preferred Accident Ins. Co. v. Musante, Berman & Steinberg Co., 133 Conn. 536, 52 A.2d 862 (1947). In contract, relief is granted when public policy would be advanced by allowing the more excusable of the two parties to recover. Ryan v. Motor Credit Co., 130 N.J. Eq. 531, 23 A.2d 607 (Ch. N.J. 1941); *see, e.g.,* Union Pac. R.R. v. Chicago & N.W. Ry., 226 F. Supp. 400, 410 (N.D. Ill. 1964).

36. Since Congress has imposed no sanction on a borrower who causes a violation of Regulation U, it would seem that in most circumstances the negligence of the bank could be found at least as culpable as the "intention" of a borrower. The borrower may only be dimly aware of the law, or he might have acted solely at the instigation of a broker who told him that signing the purpose statement was a mere formality.