

## TEXAS BANKING LAW UPDATE

Kirby D. Hopkins  
Drucker, Rutledge & Smith, L.L.P.  
10003 Woodloch Forest Drive, Suite 225  
The Woodlands, Texas 77380  
Telephone: (281) 681-3515  
Fax: (281) 681-3543  
Website: [www.drs-llp.com](http://www.drs-llp.com)  
E-mail: [hopkins@drs-llp.com](mailto:hopkins@drs-llp.com)

### Aiding and Abetting Liability under the Texas Securities Act:

*Sterling Trust Company v. Roderick Adderley, et al.*, No. 03-1001, 48 Tex. Sup. Ct. J. 887, 2005 WL 1413154 (June 17, 2005) (J. O'Neill) (J. Johnson did not participate) (rehearing denied).

### Summary

The Texas Supreme Court recently issued an unanimous (8-0) decision on aiding and abetting liability under the Texas Securities Act in the case of *Sterling Trust Co. v. Adderley*. The case concerned whether a trust company could be held liable as an aider and abettor even if it lacked knowledge of fraudulent conduct by a seller of the securities.

The case attracted considerable attention. Amicus briefs were filed by various bank and trust company trade associations, including the Association of Independent Trust Companies Inc., the Retirement Industry Trust Association, and the Texas Business Law Foundation. A combined amicus brief was filed by the Texas Society of Certified Public Accountants and the four largest certified public accounting firms in the United States.

The decision provides guidance on the construction of language in the Texas Securities Act relating to aider and abettor liability. See TEX. REV. CIV. STAT. ANN. art 581-

33F(2) (Vernon Supp. 2004-2005). Specifically, the Texas Supreme Court held that the Texas Securities Act's "reckless disregard for the truth or law" standard means that someone accused of aiding and abetting in securities fraud can be deemed liable only if they were generally aware of the fraudulent activity and assisted the primary violator in carrying out that activity.

### Importance

The trial court and court of appeals interpreted the above-quoted Texas Securities Act standard to allow aider/abettor liability even if the aider was unaware of its role in the securities violation. If left intact, those conclusions could arguably be used to extend the Texas Securities Act's provision on aiding far beyond the limits intended by the legislators who drafted the statute. The Texas Supreme Court's decision in *Sterling* should prove to be useful to those on the periphery of what someone later claims to be fraudulent activity. This could be banks, trust companies, underwriters, accountants, securities lawyers, etc. Here, the more than six million dollar jury verdict and intermediate appellate award against Sterling Trust Company, a subsidiary of Matrix Bancorp, Inc., was reversed by the Texas Supreme Court and remanded back to the trial court. While the decision does not completely insulate them from fraud, it raises the bar of liability such that, to be held liable, they must have subjective awareness of the fraud.

While the Texas Supreme Court did not hold the peripheral participant liable here, banks and others in a similar position increase their chances of avoiding such costly litigation by closely monitoring deposit and loan transactions, human resources, and adherence to banking regulations. Taking preemptive and preventative action in these

areas provides an extra layer of protection and ensures operations are conducted pursuant to safety and soundness procedures.

### Texas Securities Act Introduction

With this case, the Texas Supreme Court considers the scope of potential liability under the Texas Securities Act (“TSA”). Included within the TSA’s definition of a security are shares, stocks, notes, bonds, debentures, mortgage certificates, and other instruments commonly known as securities.

“The TSA establishes both primary and secondary liability for securities violations.” *Sterling Trust Co. v. Adderley*, 168 S.W.3d 835, 839 (Tex. 2005). Primary liability arises when a person offers or sells a security by means of a misrepresentation. *See id.* “Secondary liability is derivative liability for another person’s securities violation; it can attach to a control person, defined as a ‘person who directly or indirectly with intent to deceive or defraud or with reckless disregard for the truth or the law aids a seller, buyer, or issuer of a security,’ or to an aider, defined as one ‘who directly or indirectly with intent to deceive or defraud or with reckless disregard for the truth or the law materially aids a seller, buyer, or issuer of a security.’” *Id.* (quoting TEX. REV. CIV. STAT. ANN. art 581-33A(2), F(1)-(2)).

Both control persons and aiders are jointly and severally liable with the primary violator to the same extent as if they were the primary violator, meaning that a secondary violator may only be held liable to the same extent as the primary violator. *See id.* As such, “a secondary violator’s liability depends upon the primary violator’s culpability.” *Id.* at 845. So, “if it were proven that the seller reasonably believed its statements to be true,

defeating a necessary element of misrepresentation, there would be no primary violation and no derivative liability to attach to the aider.” *Id.*

#### Background Facts

“During the early to mid-1990s, Norman Cornelius formed Avalon Custom Homes and a number of related corporate entities designed to develop and sell luxury homes.” *Id.* at 837. “At that time, Cornelius worked as an investment advisor and broker for Sunpoint Securities.” *Id.* “Cornelius operated Avalon out of his Sunpoint office and encouraged his brokerage clients to invest their money in Avalon.” *Id.* “Cornelius also persuaded members of his church and retirees from Mrs. Baird’s Bakery to invest in Avalon, offering investors promissory notes that bore as much as an eighteen percent rate of return and allowed conversion to Avalon stock.” *Id.* at 837-38. “Many of the investors chose to invest their retirement savings in Avalon.” *Id.* at 838. “Because certain retirement accounts such as IRAs and lump-sum pension distributions must be held by a third-party trustee to maintain their preferential tax status, Avalon needed a third-party trustee in order to accept such funds.” *Id.* “In 1994, Cornelius began recommending that Avalon investors use Sterling Trust Company, a custodian of self-directed IRA accounts, as their IRA custodian. From 1994 until 1997, Sterling served as the exclusive trustee over the retirement money that the investors self-directed to Cornelius.” *Id.*

#### Evidence at Trial

The Plaintiffs, i.e., the investors, “provided evidence that Cornelius told investors that investing in Avalon carried ‘no risk’ and that any principal invested would be protected.”

*Id.* “There was also evidence that Avalon was not profitable and that early investors were paid with the proceeds of later investors, thus creating a pyramid effect that collapsed when new investments dried up.” *Id.* “This type of pyramid scheme is often referred to as a ‘Ponzi scheme.’” *Id.* at 838.

The Plaintiffs also “provided evidence that Sterling’s failure to comply with several of its own internal procedures facilitated Cornelius’s pyramid scheme and allowed Cornelius to hide the nature of his scheme from the investors.” *Id.* at 838-39. “For example, the investors showed that, although Sterling’s policies prohibited it from holding promissory notes that were in default, it nevertheless held such notes.” *Id.* at 839.

In addition, the Plaintiffs “provided evidence that Sterling failed to obtain many of the Avalon stock certificates and original promissory notes; ordinarily, Sterling employees could not enter transactions into Sterling’s computer system without such documents.” *Id.* “When low-level Sterling employees alerted management to the lack of such documents, they were told that Sterling had made an agreement allowing Avalon to retain those documents.” *Id.*

“There was also evidence that Sterling failed to obtain copies of the security agreements for the promissory notes that purported to be secured by real estate even though Sterling’s internal procedures required it to keep such documents on file.” *Id.*

“The Plaintiffs provided evidence that Sterling was aware that Cornelius was commingling investors’ funds by having one or more Avalon companies make payments on notes for which another Avalon company was indebted, and that at least one of Sterling’s internal memos questioned this practice.” *Id.*

Finally, the Plaintiffs “demonstrated that Cornelius did not pay the principal balance on a number of notes as they became due, but instead transferred the investors’ money into new investment vehicles in other Avalon entities.” *Id.* “There was also evidence that Sterling allowed Cornelius to unilaterally make such transfers despite its own policy requiring documentation of investor approval for new investments.” *Id.*

### Jury Charge

At trial, the Plaintiffs argued that the evidence supported several theories of liability. *See id.* at 838. Among other questions not relevant here, the jury charge asked:

- (1) whether each of the defendants (Cornelius, Sunpoint, Sunpoint’s owner, and Sterling) offered or sold securities by means of a misrepresentation.
- (2) whether Sterling aided Cornelius in committing securities fraud by “directly or indirectly with intent to deceive or defraud or with reckless disregard for the truth or the law materially aid[ing] a seller of a security;” (tracking the TSA’s aider standard)
- (3) whether Sterling was part of a conspiracy that damaged the investors; and
- (4) whether the defendants committed fraud against the investors.

*See id.*

### Jury Verdict

“The jury returned a verdict against Cornelius on all counts.” *Id.* at 839. “On the issues pertaining to Sterling, however, the verdict was mixed.” *Id.* “Specifically, the jury found that Sterling was not a “seller” of securities, that Sterling did not conspire to damage the investors, and that Sterling did not commit fraud.” *Id.* “However, the jury found that

Sterling aided Cornelius's securities violation." *Id.* Actual damages of approximately \$6,000,000 were awarded, plus exemplary, or punitive, damages of nearly \$250,000. See *id.*

### At the Court of Appeals

As explained above, the jury found that Sterling was secondarily liable as an aider to securities fraud. Sterling appealed the verdict, arguing that the trial court erred by failing to instruct the jury that an aider cannot be held secondarily liable unless it had a general awareness of its role in the primary violation. The Second Court of Appeals in Fort Worth then held that the failure to include such an instruction was not error, concluding that "the TSA does not require proof that an aider is generally aware of its role in the securities violation to be liable as an aider." *Sterling Trust Co. v. Adderley*, 119 S.W.3d 312, 320 (Tex. App.–Fort Worth) *rev'd*, 168 S.W.3d 835 (Tex. 2005)).

### The Texas Supreme Court's Decision

Taking its appeal a step further to the highest level, Sterling contended the Second Court's holding conflicted with opinions from other Texas courts of appeals that hold the TSA does impose a general awareness requirement. The Second Court had noted the conflict but concluded that, because the language of the TSA does not explicitly impose a general awareness requirement, the proper course was to decline to follow the opinions that have concluded that the TSA contains such a requirement. Holding in Sterling's favor, the Texas Supreme Court disagrees with the Second Court of Appeals' conclusion that the TSA contains no awareness requirement. See *Sterling*, 168 S.W.3d at 840. As the basis

for this decision, the Texas Supreme Court first points out: (a) the TSA’s legislative history demonstrates that the Texas Legislature intended the TSA to be interpreted in harmony with federal securities law; and (b) the text of the TSA even provides, “This Act may be construed and implemented to effectuate its general purpose to maximize coordination with federal and other states’ law and administration.” See TEX. REV. CIV. STAT. ANN. art 581-10-1A. Secondly, with an emphasis on federal law applicable when aider liability was added to the TSA, The Texas Supreme Court analogizes to a federal RICO Act case that held that a bank’s knowledge of an illegal scheme is required to deem it secondarily liable. See *Sterling*, 168 S.W.3d at 840-41 & n. 3 (citing *K & S P’ship v. Cont’l Bank, N.A.*, 952 F.2d 971, 977 (8th Cir. 1991) (“[A] defendant’s general awareness of its overall role in the primary violator’s illegal scheme is sufficient knowledge for aiding and abetting liability . . . . If an illegal scheme exists and a bank’s loan assists in that scheme, the bank’s knowledge of the scheme is the crucial element that prevents it from suffering automatic liability for the conduct of the insiders to whom it loaned the money.”)).

Challenging *Sterling*’s appeal, the investors had relied on a case holding that a failure to conduct minimal investigation and inquiry before rendering assistance with a securities transaction can suffice to create liability under the TSA’s “reckless disregard” standard. *Id.* at 841. The Texas Supreme Court disagrees that the TSA’s “reckless disregard’ standard either imposes a lesser standard than the ‘general awareness’ requirement or allows liability to be imposed for a mere failure to investigate.” *Id.* Instead, the Texas Supreme Court concludes that the TSA’s “reckless disregard for the truth or the law” language “accords with the requirement that an aider must be aware of the primary violator’s improper activities before it may be held liable for assisting in a securities

violation.” *Id.* As the basis for this conclusion the Texas Supreme Court explains, “When the Texas Legislature adopted the aider provision of the TSA, it explicitly stated that aider liability should be imposed ‘only if the aider had the requisite scienter (i.e., knowledge or intent).” *Id.* at 842 (quoting TEX. REV. CIV. STAT. ANN. art 581-33, Comment – 1977). According to the Texas Supreme Court, the Legislature presumably determined that policy concerns favoring a subjective scienter standard outweighed the potential investor protection available under a “should have known” standard, when it chose to adopt the “reckless disregard” standard instead of a lower negligence or “should have known” standard. *See id.* at 842.

Therefore, the Texas Supreme Court rejects the investors argument and holds: “[T]he TSA’s ‘reckless disregard for the truth or the law’ standard means that an alleged aider can only be held liable if it rendered assistance ‘in the face of a perceived risk’ that its assistance would facilitate untruthful or illegal activity by the primary violator.” *See id.* Furthermore, “[i]n order to perceive such a risk, the alleged aider must possess a “general awareness that his role was part of an overall activity that is improper.” *Id.* (quoting *Gould v. American-Hawaiian S.S. Co.*, 535 F.2d 761, 780 (3rd Cir. 1976)).

#### Additional Guidance from the Texas Supreme Court

The TSA only imposes liability if the aider acted with “intent to deceive or defraud or with reckless disregard for the truth or the law,” TEX. REV. CIV. STAT. ANN. art 581-33A(2), F(2), which requires more than mere negligence according to the holding here. *See Sterling*, 168 S.W.3d 845-46. The Texas Supreme Court provides, “Ignoring internal procedures that might have alerted Sterling to Cornelius’s scheme may be negligence, but

it is not ‘reckless disregard for the truth or the law.’” *Id.* at 843 (quoting TEX. REV. CIV. STAT. ANN. art 581-33A(2), F(2)).

The Texas Supreme Court adds, “knowledge of an illegal scheme, if proven, could support a finding that Sterling acted ‘with reckless disregard for the truth or the law’ even if Sterling could not have known of the particular misrepresentations made by Cornelius,” the seller and primary violator. *Id.* (quoting TEX. REV. CIV. STAT. ANN. art 581-33A(2), F(2)) (citing a 1997 Iowa Supreme Court case permitting aider liability under Iowa’s securities state to be based on the aider’s knowledge that the primary violator was engaging in atypical business transactions that amounted to a Ponzi scheme) (also citing a 2000 D.C. Circuit case where scienter established when aider continued to assist primary violator despite knowledge of his irrational trading and financial difficulties).

#### Sterling’s Rejected Defenses

Sterling unsuccessfully argued that it could not be liable as an aider “with respect to transactions and persons with which Sterling had no contact.” *Id.* at 843. Incorrect, says the Texas Supreme Court. “[T]he TSA does not require the aider to have had direct dealing with the defrauded party; indeed, a person who ‘materially aids a seller’ may have no contact at all with the investors.” *Id.* (citing TEX. REV. CIV. STAT. ANN. art 581-33A(2), F(2)).

Sterling also unsuccessfully argued that it could not be liable as an aider “because the jury found in Sterling’s favor on its affirmative defense that it did not know, and could not have known, of the particular misrepresentations or omissions made by Cornelius.” *Id.* at 843. Again, the Texas Supreme Court disagrees. The jury’s finding that Sterling lacked

such knowledge absolves Sterling of primary liability as a seller, but does not establish that it could not be held liable as an aider through a more general awareness. *See id.* at 843-46.

#### More to Come

“In this case, the jury may have agreed that Sterling could not have known what Cornelius was telling the investors but nevertheless believed that Sterling knew that Cornelius was operating an illegal pyramid scheme.” *Id.* at 846. Because the jury in this case was asked only whether Sterling knew of the misrepresentation, the jury’s “no” answer “does not shed light on whether the jury believed that Sterling knew Cornelius was engaged in illegal activity.” *Id.* The Texas Supreme Court further holds that the jury’s finding “that Sterling ‘did not know, and in exercise of reasonable care could not have known of the untruth or omission’ is not dispositive of the question of whether Sterling had knowledge of the underlying wrongdoing.” *Id.* Because the case was remanded back to the trial court for the jury to be given the correct instruction regarding aider liability requiring general awareness, the ultimate legal and financial liability of Sterling remains uncertain.

Finally, the Texas Supreme Court also remanded breach of fiduciary issues for further determination.

## Sources

*Case Summaries, Texas Supreme Court, Securities Law*, TEXAS LAWYER, June 27, 2005.

Mary Alice Robbins, *Ruling Resolves Conflict among Courts of Appeals, Liability for Aiding Requires Awareness of Role of Assistance*, TEXAS LAWYER, June 27, 2005, at 1.

Roger Bartlett, David Keyes, Gail Merel, Scott Sheehan, *2004 Legal Perspective: Business Law*, 68 Texas Bar Journal 1, 28.