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SECURITIES LAW: A CONSERVATIVE APPROACH

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During the 1978-79 term, the United States Court of Appeals for the Seventh Circuit decided a number of cases involving securities and commodities law.¹ Some may have significant future impact. In general, however, the more "traditional" types of cases,² such as standing and the sale of securities, were decided in line with established precedent. Only one 1978-79 securities case deviated from precedent.³ In that case, the Seventh Circuit sought to restrict private litigation in an area in which such a right has been allowed by other circuits for a number of years.⁴ However, in this case, as in most of the securities cases decided this term, the Seventh Circuit followed the lead of the United States Supreme Court by not extending any private rights of action.⁵

FRAUD IN A WILLIAMS ACT TENDER OFFER

Since the late 1960's, the decided trend in American corporate life has been toward combining or affiliating with other corporations. Such business combinations may be effected through a variety of methods which include merger, consolidation, purchase of assets or tender offer.⁶ The use of tender offers has become increasingly popular and because of the potential for abuse, especially from the shareholders' point

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1. *O'Brien v. Continental Illinois Nat'l Bank & Trust Co.*, 593 F.2d 54 (7th Cir. 1979); *Nemkov v. O'Hare Chicago Corp.*, 592 F.2d 351 (7th Cir. 1979); *Hunt v. Commodities Future Trading Comm'n*, 591 F.2d 1234 (7th Cir. 1979); *Bastian v. Lakefront Realty Corp.*, 581 F.2d 685 (7th Cir. 1978); *Capos v. Mid-America Nat'l Bank*, 581 F.2d 676 (7th Cir. 1978); *Indiana Nat'l Bank v. Mobil Oil Corp.*, 578 F.2d 180 (7th Cir. 1978).

2. *See O'Brien v. Continental Illinois Nat'l Bank & Trust Co.*, 593 F.2d 54 (7th Cir. 1979); *Nemkov v. O'Hare Chicago Corp.*, 592 F.2d 351 (7th Cir. 1979).

3. *Capos v. Mid-America Nat'l Bank*, 581 F.2d 676 (7th Cir. 1978).

4. *See Smith v. Bear*, 237 F.2d 79, 87-88 (2d Cir. 1956); *Serzysko v. Chase Manhattan Bank*, 290 F. Supp. 74, 78 (S.D.N.Y. 1968), *aff'd*, 409 F.2d 1360 (2d Cir. 1969), *cert. denied*, 396 U.S. 904 (1970); *Remar v. Clayton Securities Corp.*, 81 F. Supp. 1014, 1017 (D. Mass. 1949).

5. *See Bastian v. Lakefront Realty Corp.*, 581 F.2d 685 (7th Cir. 1978).

6. A tender offer is not defined either in the Williams Act or in the rules under the Securities and Exchange Act. However, several courts have attempted to define the term. *See Cattleman's*

of view, Congress amended the Securities and Exchange Act of 1934 by the addition of sections 13(d),⁷ 13(e),⁸ 14(d),⁹ 14(e)¹⁰ and 14(f).¹¹ These sections are commonly called "The Williams Act" after their sponsor, Senator Harrison Williams of New Jersey. The Williams Act is designed to protect the shareholder of the target corporation whose stock is sought to be acquired by the bidder corporation.¹²

As with the Securities Act of 1933,¹³ the primary emphasis of the Williams Act is disclosure to the investor.¹⁴ The Williams Act requires that any cash tender offer for securities of an issuer, registered pursuant to section 12 of the Securities and Exchange Act,¹⁵ shall be filed with the Securities and Exchange Commission¹⁶ prior to, or contemporaneous with, its public announcement.¹⁷ Certain basic disclosures must be provided to the target company's shareholders so that they can be in a position to make informed, intelligent decisions as to the tender of their shares.¹⁸

Notice to the shareholders of the existence of the tender offer and

Inv. Co. v. Fears, 343 F. Supp. 1248, 1251-52 (W.D. Okla. 1972); *Nachman Corp. v. Halfred, Inc.*, [1973] 91 FED. SEC. L. REP. (CCH) ¶ 94,455.

On November 29, 1979, in Securities Act of 1933 Release No. 6159, the Commission proposed an amendment to rule 14d-1(b)(1), 17 C.F.R. §§ 240.14d-1(b)(1), which would define the term "tender offer." As proposed, the term would include one or more offers to purchase which (1) during any forty-five day period are directed to more than ten persons and seek over five percent of the class of securities, with the exception of certain limited purchases through a broker/dealer at the current market price or (2) which are not otherwise tender offers under the proposed rule but which are disseminated in a widespread manner, provide for a premium in excess of the greater of five percent of or \$2 above the current market price and do not provide for a meaningful opportunity to negotiate price and terms. For an excellent article on the subject, see Einhorn & Blackburn, *The Developing Concept of Tender Offer: An Analysis of the Judicial & Administrative Interpretations*, 20 CORP. PRAC. COM. 281 (1978).

7. 15 U.S.C. § 78m(d) (1976).

8. *Id.* § 78m(e).

9. *Id.* § 78n(d).

10. *Id.* § 78n(e).

11. *Id.* § 78n(f).

12. See H.R. REP. NO. 1418, 88th Cong., 2d Sess., reprinted in [1964] U.S. CODE CONG. & AD. NEWS 3013.

13. 15 U.S.C. §§ 77a-77aa (1976).

14. This is consistent with the intent of both the Securities Act of 1933, 15 U.S.C. § 77 (1976), and the Securities and Exchange Act of 1934, 15 U.S.C. § 78 (1976).

15. 15 U.S.C. § 78j (1976).

16. Hereinafter referred to as the SEC.

17. 15 U.S.C. § 78j (1976).

18. 17 C.F.R. § 240.14d-1 (1979). Schedule 14d-1 under the Securities and Exchange Act requires the following information: the name of the security and the target company; the identity and background of the bidder; past contracts, transactions or negotiations between the bidder and the target; the source and amount of funds or other consideration which finance the purchase and the bidder's plans concerning the target; the securities ownership of the target by the bidder; any contracts, understandings or relationships between the bidder and the target; the identity of persons used by the bidder to make solicitations; financial statements of the bidder in certain cases; and other material information that is necessary for the shareholder to make his decision. *Id.*

its terms and conditions is the heart of the Williams Act. In *Indiana National Bank v. Mobil Oil Co.*,¹⁹ the Seventh Circuit decided that notice of the termination of a tender offer was adequate when given in a press release.

On August 13, 1974, Mobil Oil Company²⁰ made a cash tender offer to the shareholders of Marcor, Inc. to purchase 17,250,000 shares.²¹ Like most tender offerors, Mobil permitted different methods of tendering shares. The first method was by actual delivery of the share certificates to the depository or to one of its forwarding agents. A second method was not available to all shareholders, but only to "eligible institutions" which included commercial banks and trust companies, members of national securities exchanges and members of the National Association of Securities Dealers. These eligible institutions, or shareholders tendering through them, did not have to immediately deposit their stock certificates. All that was required was that the depository or forwarding agent receive a properly executed letter of transmittal and a guarantee of delivery. However, the shares had to be actually deposited within eight days after Mobil's public announcement of the termination of Mobil's offer.

The plaintiff banks, as eligible institutions, forwarded properly executed delivery guarantees to the depository. Then, on August 26, 1974, Mobil transmitted a press release to all the wire services, trade journals, newspapers, radio and television announcing the close of its offer. However, plaintiffs did not deposit their Mobil shares within the eight-day period after the press release regarding termination of the offer. Therefore, Mobil declined to purchase any of the shares.

Plaintiffs' complaint contained allegations that Mobil failed to make a required public announcement and made fraudulent omissions regarding how the public announcement would be made.²² The plaintiffs also contended that they were entitled to sell the subject shares to Mobil based on the plaintiffs' completion of the first phase of the delayed delivery option.

The Seventh Circuit in *Indiana National Bank* held that the plaintiffs had not met the terms of Mobil's tender offer because of their failure to deposit the securities within eight days of the announcement.

19. 578 F.2d 180 (7th Cir. 1978).

20. Hereinafter referred to as Mobil.

21. As required by section 14(d)(6) of the Williams Act, Mobil agreed to accept, pro rata, all shares tendered if the total exceeded 17,250,000. In fact, over 33,000,000 shares were ultimately tendered. *Id.* at 182.

22. See 15 U.S.C. § 78n(e) (1976).

Therefore, according to the court, the plaintiffs were not entitled to pro-rata sales to Mobil.²³ The Seventh Circuit also found that Mobil made a satisfactory public announcement on August 26, 1974, by transmitting a press release to the wire services and other news media.²⁴ The court said that the term "public announcement" has a generally understood meaning and is satisfied by the issuance of a properly disseminated press release. The court noted that proposed rule 14e-2²⁵ would require any extension of a tender offer to have been disclosed first by a press release or other public announcement.²⁶ The court concluded that there was no right to individual or personal notice simply because the plaintiffs had complied with the first part of the tender offer's terms, and further reminded the plaintiffs that they were sophisticated professionals to whom such a press release was reasonable notice.

In *Indiana National Bank*, the Seventh Circuit paid close attention to the views of the Supreme Court as expressed in *Piper v. Chris-Craft Industries, Inc.*²⁷ The Seventh Circuit chose not to expand available causes of action under the Williams Act, especially when such an expansion would have required the court to stretch the definition of a "public announcement" beyond the industry's accepted meaning and practice.

PRIVATE ACTIONS FOR FAILURE TO REGISTER UNDER THE EXCHANGE ACT

Under section 12(g) of the Securities and Exchange Act,²⁸ when an issuer attains the status of \$1 million in assets and concurrently has over 500 holders of a class of equity securities, the issuer is automatically required to register that class of equity security with the SEC,²⁹ file periodic reports,³⁰ comply with the proxy rules,³¹ and abide by

23. 578 F.2d 180, 184 (7th Cir. 1978).

24. *Id.* at 185-87.

25. See 16 Sec. Docket 973 (Feb. 20, 1979).

26. The court also quoted from the New York Stock Exchange Company *Manual*, which provides that "(t)he normal method of publication of important corporate data is by means of a press release." 578 F.2d 180, 185 (7th Cir. 1978).

27. *Piper v. Chris-Craft Indus., Inc.*, 430 U.S. 1 (1977). In *Piper*, the Supreme Court held that a bidder in a tender offer does not have standing to sue under section 14(e). The Court stated that the congressional intent of section 14(e) was to protect the shareholders of the target company and bidders, as the regulated class under the statute, were not intended to be protected by the legislation. *Id.* at 44-48.

28. 15 U.S.C. § 78l(g) (1976).

29. *Id.*

30. *Id.* § 78(m). The periodic reports include an annual report on form 10-K, a quarterly report on form 10-Q and a current report on form 8-K.

31. 15 U.S.C. §§ 78n(a), 78n(b), 78n(c) (1976). See also 17 C.F.R. § 240.14a-101 (1979).

other substantive provisions of the Securities and Exchange Act.³² The case of *Bastian v. Lakefront Realty Corp.*³³ involved questions concerning when an issuer's requirement to register under section 12(g) begins and what, if any, liability is incurred by an issuer's failure to register.

The plaintiff in *Bastian*, a member of the Lake Shore Club of Chicago³⁴ sued Lakefront Realty³⁵ and the club on behalf of all Lakefront stockholders to enjoin a proposed sale of the club's building and property. All members were stockholders of Lakefront because they were required to purchase Lakefront stock in order to join the club. Lakefront had been organized by the club to hold, maintain and lease to the club the land and structure which served as the club's clubhouse. After negotiations between Lakefront and the club to renew the club's lease were unsuccessful, Lakefront negotiated the sale of the property to Northwestern University.³⁶ In March, 1977, after the negotiations had failed, Lakefront sent its shareholders a letter from its directors concerning the proposed sale which contained a notice of a meeting to vote on the sale of the property and a proxy. Two-thirds of the votes cast were in favor of the sale and the motion passed. The plaintiff, alleging seven causes of action, sued to enjoin the sale. Count I alleged violation of the federal proxy rules; count II alleged failure to register pursuant to section 12 (g) of the Securities and Exchange Act; counts III and IV alleged failure to file reports on corporate finances and insider stockholdings; and counts V through VII invoked pendent state law claims.

Concerning the allegations in count II regarding Lakefront's failure to register, the facts in *Bastian* were as follows. Prior to October, 1968, the defendant had at one time over 500 shareholders, but at the time of the proxy solicitation had less than 300 shareholders. The defendant had never registered pursuant to section 12(g) and therefore had also never deregistered.³⁷

Plaintiff's requested relief was denied by the lower court.³⁸ The

32. When an issuer becomes a reporting company, officers, directors and 10% shareholders of the reporting company are required to file reports of stock ownership in the reporting company and may be held liable for any profits made in transactions of the reporting company's stock that have occurred within a six month period. Five percent shareholders are required to file ownership reports. Tender offers for the stock of a reporting company must comply with the provisions of the Williams Act. 15 U.S.C. §§ 78m(d), 78m(e), 78n(d), 78n(e), 78n(f) (1976).

33. 581 F.2d 685 (7th Cir. 1978).

34. Hereinafter referred to as the club.

35. Hereinafter referred to as Lakefront.

36. 581 F.2d at 688.

37. See 15 U.S.C. § 78l (g)(4) (1976).

38. See 581 F.2d at 689.

plaintiff was also unsuccessful at the appellate court level with the argument that since defendant at one time was required to have registered with the SEC it should have done so, even if it could have deregistered upon attaining less than 300 shareholders.³⁹ The court noted that the SEC has no discretion to deny deregistration if the shareholder condition is met and that the issuer is automatically relieved of its Securities and Exchange Act obligations within ninety days of the filing of its application to deregister.⁴⁰

The court in *Bastian* did not address itself to the alleged lack of registration, but stated that even if Lakefront should have registered, a finding that the proxy provisions still applied to Lakefront due to Lakefront's lack of deregistration would be to require "an idle and useless act."⁴¹ According to the Seventh Circuit, the Securities and Exchange Act contains no provisions indicating a congressional intent to abrogate the usual rule that the law does not require an unnecessary act.⁴² Since there was no liability for failure to register, the proxy rules had no application and the Seventh Circuit affirmed the district court as to count I.⁴³ The Seventh Circuit further affirmed the district court with regard to the remaining counts on the basis that the plaintiff had not shown any likelihood of success on the merits and had failed to show irreparable injury to the plaintiffs.⁴⁴

It is useful to compare the Seventh Circuit's opinion in *Bastian* to *Kerber v. Kakos*,⁴⁵ a federal district court case involving a motion to dismiss which was decided several years ago by Judge Prentice Marshall. In *Kerber*, the court held that section 12(g) contained an implied right of action in the public even though there is no express provision in the statute itself.⁴⁶ Judge Marshall noted that Congress enacted sec-

39. *Id.*

40. *Id.*

41. *Id.* at 690. The court short-changed the plaintiff when it held that registration and compliance with the proxy rules would be useless acts. The "useless act" would have provided a full measure of disclosure to the plaintiff at the time of the proxy solicitation by Lakefront. If Lakefront decided thereafter that it wished to deregister, the desire could be easily effected.

The whole premise of the federal securities laws is disclosure. When a doubt exists as to whether disclosure should be mandated in a certain case, the decision should be made in favor of disclosure. The innocent plaintiff should not be penalized for the violation of the defendant, over which the plaintiff had no control.

42. *Id.*

43. *Id.* at 692.

44. *Id.* The sale to Northwestern University was on terms more favorable than those which had been rejected by the club.

45. 383 F. Supp. 625 (N.D. Ill. 1974).

46. In *Kerber*, Judge Marshall relied heavily on *Kardon v. National Gypsum Co.*, 69 F. Supp. 512 (E.D. Pa. 1946). The *Kardon* court held that, with regard to a private suit for violation of rule 10b-5 under the Securities and Exchange Act, such a right of action was implied in order to

tion 12 of the Securities and Exchange Act so that security holders of non-exchange listed companies would have the same information disclosed to them as their counterparts listed on the exchange.⁴⁷ In *Kerber*, the court emphasized that a “threshold violation of section 12 may well strip an investor of many of the protections Congress intended that he have.”⁴⁸

The Seventh Circuit in *Bastian* did not mention *Kerber* or delve into the legislative history of section 12. The *Bastian* decision is, to some extent, contrary to the congressional intent behind section 12 of providing disclosure to security holders of non-exchange listed companies.⁴⁹

The Seventh Circuit emphasized that it would be a useless act to require deregistration of Lakefront since that company had fewer than 300 shareholders for several years. Nevertheless, the company was allowed to consider itself a non-reporting company without any action on its part or notice to its security holders. Thus, *Bastian* countenances a “mild” violation of the securities laws. It is hoped that *Bastian* will not be used again to justify violations on the basis of “no harm, no foul.”⁵⁰

SUIT UNDER THE COMMODITY FUTURES TRADING ACT

The SEC and the Commodity Futures Trading Commission⁵¹ each have three avenues of approach to redress violations of the laws each enforces.⁵² These avenues include a civil suit brought by the agency in federal district court,⁵³ an administrative proceeding brought before the agency’s administrative law judge,⁵⁴ and recommendation for criminal indictment to the Department of Justice.⁵⁵

further congressional intent in enacting the statute. See also *J.I. Case Co. v. Borak*, 377 U.S. 426 (1964).

47. H.R. REP. NO. 1418, 88th Cong., 2d Sess., reprinted in, [1964] U.S. CODE CONG. & AD. NEWS 3013.

48. 383 F. Supp. 625, 629 (N.D. Ill. 1974).

49. See 31 VAND L. REV. 1513 (1978).

50. The company in *Bastian* was not a reporting company. If the company had been such a reporting company, one wonders if the court would have been so liberal in interpreting the deregistration provisions of the Securities and Exchange Act. *Bastian* would have considerable precedential value in a case where a reporting company had less than 300 shareholders but had not deregistered. In the latter case, the company ought not to be relieved of its reporting and proxy requirements as there is a justifiable expectation on the part of the shareholders that the company will be providing current, material information. Unfortunately, one can only speculate until a case with those facts is heard by the court.

51. Hereinafter referred to as the CFTC.

52. 7 U.S.C. §§ 6, 9, 13a (1976).

53. *Id.* § 13a.

54. *Id.* § 9.

55. *Id.* § 6.

In *Hunt v. Commodity Futures Trading Commission*,⁵⁶ the CFTC instituted an administrative proceeding under section 6(b) of the Commodity Exchange Act⁵⁷ at the same time that it brought an action in federal district court for an injunction and other ancillary relief.⁵⁸ The members of the Hunt family sued to enjoin the CFTC from bringing an administrative proceeding at the same time that the CFTC was also seeking injunctive relief. The Hunts' position was that since the CFTC chose to sue in district court, the CFTC was barred from instituting administrative proceedings. The Hunts further contended that the CFTC violated its own discovery rules⁵⁹ by adopting the evidentiary record developed in the district court for use in the administrative proceedings. These arguments were not persuasive to the district court which denied issuing either a temporary restraining order or a preliminary injunction.⁶⁰ The Hunts appealed to the Seventh Circuit.

The Seventh Circuit disposed of the Hunts' administrative remedies under the Administrative Procedure Act.⁶¹ Referring to a long line of cases,⁶² the court stated that it is a "long settled rule of judicial administration that no one is entitled to judicial relief for a supposed or threatened injury until the prescribed administrative remedy has been exhausted."⁶³ The Seventh Circuit noted that under certain exemptions to the exhaustion doctrine, a court may interrupt administrative proceedings.⁶⁴ The court determined, however, that no such exemptions existed in *Hunt*. The Seventh Circuit found that there was nothing in the Commodity Exchange Act or its legislative history which indicated that the CFTC was required to make an election of remedies.⁶⁵ Judge Markey of the United States Court of Customs and Patent Appeals, sitting by designation in *Hunt*, registered a strong dissent.⁶⁶ In the dissent, Judge Markey stated that the CFTC should be precluded from bringing any administrative proceedings until the termination of the civil action in accordance with the policy of the avoid-

56. 591 F.2d 1234 (7th Cir. 1979).

57. *Id.* at 1236.

58. The CFTC also sought disgorgement of profits.

59. 591 F.2d at 1236. *See also* 17 C.F.R. § 10.42(b) (1977).

60. 591 F.2d at 1236.

61. 5 U.S.C. §§ 500-76 (1976).

62. *See Rosenthal & Co. v. Bagley*, 581 F.2d 1258, 1259 (7th Cir. 1978); *Squillacote v. International Bhd. of Teamsters*, 561 F.2d 31 (7th Cir. 1977); *Grutka v. Barboor*, 549 F.2d 5 (7th Cir.), *cert. denied*, 431 U.S. 908 (1977); *Frey v. Commodity Exch. Auth.*, 547 F.2d 46 (7th Cir. 1976).

63. 591 F.2d at 1236, *quoting Myers v. Bethlehem Shipbldg. Corp.*, 303 U.S. 41, 50-51 (1938).

64. 591 F.2d at 1235.

65. *Id.* at 1236-37. *See, e.g.*, H.R. REP. NO. 95-1181, 95th Cong., 2d Sess. 51, *reprinted in*, [1978] U.S. CODE CONG. & AD. NEWS 2087.

66. 591 F.2d at 1237-43.

ance of multiple litigation.⁶⁷

It is not unusual for an agency's investigation to lead to both a civil injunctive suit and an administrative proceeding. Facts uncovered in an investigation can be material to issues in a civil injunction action and an administrative proceeding. It is also not unusual for both types of enforcement actions to be brought at or about the same time. The civil injunctive actions are filed to stop prohibited, violative conduct with the possibility of criminal contempt for further violations. Administrative actions are filed in furtherance of an agency's obligation to police the industry it licenses. Possible sanctions resulting from an administrative proceeding brought by the CFTC or SEC range from a censure of conduct or the revocation of the license of a registered entity, to the prohibition from further practice in the area of commodities or securities transactions. To rule that regulatory agencies would be required to elect remedies would be to unduly restrict them. The availability of various remedies provides more flexibility to regulatory agencies. The Seventh Circuit's opinion in *Hunt* evidences the court's recognition of the necessity of both administrative and judicial remedies to agencies like the CFTC and SEC to regulate the market and protect the public.

EXTENSION OF CREDIT AND REGULATION U

In order to protect the integrity of the securities markets, particularly with regard to the extension of credit for the purpose of purchasing securities, the Federal Reserve Board, at the request of Congress, promulgated regulations T,⁶⁸ U⁶⁹ G,⁷⁰ and X.⁷¹ Although these regulations are Federal Reserve Bank rules and are interpreted by that body, they are enforced by the SEC as a part of its oversight of the securities industry. Regulation T deals with the extension of credit by a broker-dealer to its customer,⁷² regulation U with credit given by a bank to a customer for purposes of purchasing securities,⁷³ regulation G with loans to investors by any other lender for the same purpose,⁷⁴ and regulation X deals with prohibiting the borrower from violating any of the

67. *Id.*

68. 12 C.F.R. §§ 220.1-220.129 (1979).

69. *Id.* §§ 221.1-221.4.

70. *Id.* §§ 207.1-207.5.

71. *Id.* §§ 224.1-224.6.

72. *Id.* §§ 220.1-220.129.

73. *Id.* §§ 221.1-221.4.

74. *Id.* §§ 207.1-207.5.

Federal Reserve's Extension of Credit Rules.⁷⁵ The first three regulations are similar in their operation with regard to use of securities for collateral. Unless the securities are eligible securities,⁷⁶ collateral other than the securities to be purchased must be used to secure the loan. The ineligible margined securities are considered to have no loan value. Securities deemed eligible for credit are also not given 100% value for collateral purposes but rather some lesser percentage.⁷⁷

Although not usually the subject of private litigation, the Seventh Circuit last term had occasion to decide a credit-purchase securities case, *Capos v. Mid-America National Bank*.⁷⁸ In *Capos*, the Seventh Circuit had the opportunity to decide whether an investor has a cause of action against a lender who does not sell the investor's collateralized stock when the market indicates a decline in the stock's value. In 1969, Capos had a \$145,000 loan outstanding with the Mid-America National Bank secured by 6,000 shares of Metals Corporation stock which was eligible for loan purposes under regulation U. At that time, there was no problem with regulation U.

Capos then borrowed an additional \$22,000 secured by 4,000 more shares of Metals Corporation. The purpose of the second loan was stated to be to purchase more Metals Corporation stock.⁷⁹ The stock began to decline in value from \$60 per share in 1968 to \$21 per share in 1969, and finally to \$3.20 per share several years thereafter. The stock was never sold by the bank since Capos and the bank negotiated and implemented a principal repayment plan. It should be noted that Capos was aware of the decreasing value of the Metals Corporation stock.

Capos sued the bank alleging a violation of regulation U because the bank loaned him \$4,600 more than it should have. In addition to the alleged regulation U violation, Capos also sued on a common law theory that a bank, holding stock as collateral for a loan, not only has a right but a duty to foreclose on the collateral if its value should approximate the amount owed.

The Seventh Circuit expressed doubt as to whether a private cause of action exists for violation of regulation U.⁸⁰ This point, however, was merely dicta in the decision since the court disposed of *Capos* on

75. *Id.* §§ 224.1-224.6.

76. The Federal Reserve Board maintains a list of eligible securities.

77. The Federal Reserve Board regularly reassesses this percentage. The Board will raise or lower it in line with overall monetary policy.

78. 581 F.2d 676 (7th Cir. 1978).

79. The loan value at that time was 20% of the securing stock or \$17,400. *Id.* at 678.

80. *Id.* at 678-79.

the basis of the running of the statute of limitations and found no limitations period specified in the Securities and Exchange Act for such actions. The Seventh Circuit adopted the limitations period from Illinois, the forum state which best effectuated the federal policy at issue.⁸¹ Although Capos had argued for a five-year limitations period based upon an Illinois statute dealing with actions for the recovery of damage for injury to property,⁸² the Seventh Circuit disagreed and held that a two-year limitation period set for actions for statutory penalties in Illinois applied.⁸³ The court could not find any injury to Capos by the bank because of the violation of Regulation U. In fact, the Seventh Circuit found that Capos received more money as a loan to him than he ought otherwise to have received. The court stressed that regulation U was meant to prohibit the loan by the bank; hence, the bank was the party injured by the violation, not Capos.

Capos fared no better with his common law count. The Seventh Circuit noted from the evidence admitted at the trial court that Capos was at all times aware of the value of the Metals Corporation stock and could have instructed the bank to sell the stock and liquidate the debt. The court characterized the loss involved with the stock's diminution in value as an investment loss, the occurrence of which was largely in the hands of Capos and not the bank. Illinois common law, the court held, does not impose any duty on a pledgee to liquidate collateral at a time when it is depreciating in value.⁸⁴ In addition, section 9-207(1) of the Uniform Commercial Code provides, in pertinent part :

A secured party must use reasonable care in the custody and preservation of collateral in possession.⁸⁵

Although the Seventh Circuit found section 9-207(1) determinative, the court further looked to section 18 of the Restatement of Security⁸⁶ which provides that "[t]he pledgee is not liable for a decline in the value of pledged instruments, even if timely action could have prevented such decline." Thus, the Seventh Circuit affirmed the district court's judgment in favor of the bank.

It should be no surprise, however, that the court in *Capos* concluded that no private cause of action exists for violation of regulation U by the customer's trading bank. After the enactment of regulation X by the Federal Reserve Board in 1970, courts changed their position

81. *Id.*

82. See ILL. REV. STAT. ch. 83, § 16 (1977).

83. *Id.*

84. 581 F.2d 676, 681 (7th Cir. 1978).

85. ILL. REV STAT.. ch. 26, § 9-207(1) (1977).

86. RESTATEMENT OF SECURITY § 18 (1941).

regarding the existence of a private right of action for violations of the margin rules.⁸⁷ Since 1970, a growing body of case law has held that no such private right of action exists.⁸⁸ The reason most often given to justify this change is that by promulgating regulation X, the Federal Reserve Board meant to place the responsibility for compliance with the margin requirements on the customer as well as the broker.⁸⁹ Since both the customer and the broker are now required to comply with the margin requirements, there is no basis for the continuing validity of the rationale allowing a private right of action. One recent case held that no private right of action exists to remedy a lender's violation of the margin requirements, even if the violation antedated the passage of regulation X.⁹⁰ In *Capos*, the Seventh Circuit again followed the lead of the Supreme Court in restricting private litigation involving the federal securities laws whenever possible.⁹¹

DEFINITION OF A SALE

A voting trust is a means whereby owners of securities relinquish some of their rights in the securities which they own, principally the right to vote those securities.⁹² The owner places his shares in a trust, under the control of a trustee, along with other owners who do likewise. The trustee then has the sole power to vote the shares, in accordance with the terms of the trust.⁹³ Each owner will receive new securities in the form of voting trust certificates indicating his interest in the trust.

87. *Pearlstein v. Scudder & German Inc.*, 429 F.2d 1136 (2d Cir. 1970); *Junger v. Hertz, Neumark & Warner Inc.*, 426 F.2d 805 (2d Cir. 1970); *Livingston v. Weis, Voisin, Cannon, Inc.*, 294 F. Supp. 676 (S.D.N.Y. 1968); *Serzysko v. Chase Manhattan Bank*, 290 F. Supp. 74 (S.D.N.Y. 1968), *aff'd*, 409 F.2d 1360, *cert. denied*, 396 U.S. 904 (1969); *Moscarelli v. Stamm*, 288 F. Supp. 453 (E.D.N.Y. 1968); *Fisch v. Banks*, 58 Misc. 2d 839, 296 N.Y.S. 2d 830 (1969); *Meyer v. Schields & Co.*, 267 N.Y.S. 2d, 25 A.2d 126 (1966).

88. *Utah State Univ. v. Bear, Stearns & Co.*, 549 F.2d 164 (10th Cir.), *cert denied*, 434 U.S. 890 (1977); *Etalblissement Tomis v. Shearson Hayden Stone, Inc.*, 459 F. Supp. 1355 (S.D.N.Y. 1978); *Nussbacher v. Chase Manhattan Bank*, 444 F. Supp. 973 (S.D.N.Y. 1977); *Drasner v. Thomson McKinnon Sec., Inc.*, 433 F. Supp. 485 (S.D.N.Y. 1977); *Freeman v. Marine Midland Bank*, [1979] FED. SEC. L. REP. (CCH) ¶ 96,902; *Schy v. FDIC*, [1977-78] FED. SEC. L. REP. (CCH) ¶ 96,242; *Theoharous v. Bache & Co.*, [1977-78] FED. SEC. L. REP. (CCH) ¶ 96,281.

89. See cases in note 87 *supra*.

90. See, e.g., *Utah State Univ. v. Bear Stearns & Co.*, 549 F.2d 164 (10th Cir.), *cert denied*, 434 U.S. 890 (1977).

91. See *Freeman v. Marine Midland Bank*, [1979] FED. SEC. L. REP. (CCH) ¶ 96,902.

92. See *Santa Fe Indus. Inc. v. Green*, 430 U.S. 462 (1977); *Piper v. Chris-Craft Indus., Inc.*, 430 U.S. 1 (1977); *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976); *United Housing Found., Inc. v. Forman*, 421 U.S. 837 (1975); *Blue Chip Stamps v. Manor Drug Stores Inc.*, 421 U.S. 723 (1975).

93. See *Lehrman v. Cohen*, 43 Del. Ch. 222, 222 A.2d 800 (1966); *Ringling Bros.-Barnum & Bailey Combined Shows v. Ringling*, 29 Del. Ch. 610, 53 A.2d 441 (1947).

Such trusts typically last ten years but can be renewed after that time.⁹⁴

In *Nemkov v. O'Hare Chicago Corp.*,⁹⁵ the plaintiffs owned shares of stock in the defendant corporation. In 1969, defendant Karlos asked the plaintiffs to participate in a voting trust. Pursuant to the trust, plaintiffs delivered their shares to the defendant trustee, the La Salle National Bank and received voting trust certificates. Plaintiffs did not know at that time, and did not learn until 1971 that they had relinquished their voting rights for ten years. The plaintiffs filed their complaint until 1971 and alleged violations of section 17(a)(2)⁹⁶ of the Securities Act, section 10(b) of the Securities and Exchange Act⁹⁷ and rule 10b-5.⁹⁸ The plaintiffs alleged fraud and asked to have the agreement rescinded and their stock returned. The district court ruled that the action was time barred; that the exchange of stock for voting trust certificates did not constitute a purchase or sale for purposes of section 10(b) or rule 10b-5; and that the plaintiffs failed to allege "scienter" for purposes of the section 17(a)(2) claim.⁹⁹ Thus, the district court dismissed the complaint¹⁰⁰ for failure to state a claim upon which relief could be granted.¹⁰¹

The Seventh Circuit affirmed the decision of the district court,¹⁰² but only on the basis of failure to institute a timely law suit. The court held that since there are no statutes of limitation for sections 17(a)(2), 10(b) and rule 10b-5, the three-year Illinois statute of limitations¹⁰³ for similar actions¹⁰⁴ was applicable. Plaintiffs' contention that the Illinois statute of limitations was inapplicable because the plaintiff was seeking equitable rather than legal relief was discussed but ultimately rejected by the court. The Seventh Circuit stated that equitable jurisdiction is concurrent with legal jurisdiction and thus concluded that if the action at law was barred, so too was the equitable action.¹⁰⁵

Nemkov is perhaps more significant for what the Seventh Circuit did not decide. The court did not address the issue of whether there was a purchase when plaintiffs exchanged their securities. It passed

94. *See, e.g.*, *Galler v. Galler*, 32 Ill. 2d 16, 203 N.E.2d 577 (1965).

95. 592 F.2d 351 (7th Cir. 1979).

96. 15 U.S.C. § 77q(a)(2) (1976).

97. *Id.* § 78j(b).

98. 17 C.F.R. § 240.10b-5 (1979).

99. *See, e.g.*, *Trussell v. United Underwriters Ltd.* 288 F. Supp. 757 (D. Colo. 1964).

100. 592 F.2d at 353-4 n.2.

101. FED. R. CIV. P. 12(b)(6).

102. 592 F. 2d at 356.

103. *See* ILL. REV. STAT. ch.121½, § 137.13(D) (1977).

104. *Id.* This section pertains generally to securities violations.

105. 592 F.2d at 355-56.

over this issue and found that plaintiffs' action was barred by the Illinois statute of limitations.

Nemkov should have begun with the question of whether any claim existed under the anti-fraud provisions and then proceeded to the applicable statute of limitations for such a determination of whether a purchase, sale, or gift had taken place should have been made since the anti-fraud provisions apply only to purchases or sales, and not to gifts. In *Nemkov*, there was an exchange of securities.¹⁰⁶

Exchanges have been held to be sales in the Seventh Circuit since 1946¹⁰⁷ when the court found that an offer to exchange beneficial trust certificates for limited partnership interests constituted a sale for purposes of section 2(3) of the Securities Act of 1933.¹⁰⁸ Other case law has supported this proposition.¹⁰⁹

An offer to exchange securities involves a new investment decision on the part of the exchanging party. This decision-making process differentiates an exchange from a gift since in the latter there is no volition on the part of the recipient of the gift; the donee simply accepts what is given without the requirement of having to give something in return. Congress recognized an exchange to be a sale when it enacted sections 3(a)(9)¹¹⁰ and 3(a)(10)¹¹¹ of the Securities Act of 1933 which are transaction exemptions from section 5 of the Act for certain exchanges. Logically, these exemptions would have been unnecessary had all exchanges been thought not to be sales.

It is unfortunate that the Seventh Circuit chose to base its opinion on the limitations question and completely bypass the issue of whether a sale took place. The court should have first determined the sale question. It is hoped that the *Nemkov* case will be cited only for the statute of limitations holding and not for the implied holding that no sale took place under section 2(3) of the Securities Act.¹¹²

106. *Id.* at 353.

107. *United States v. Wernes*, 157 F.2d 797 (7th Cir. 1946).

108. 15 U.S.C. § 77b(3) (1976).

109. *SEC v. Datronics Engineers, Inc.*, 490 F.2d 250 (4th Cir. 1973), *cert. denied*, 416 U.S. 937 (1974). No less eminent an authority than Professor Louis Loss also supports the conclusion that a sale occurs when an exchange of securities takes place. According to Professor Loss, "[i]t is clear on the face of the statute [Section 2(3) of the Securities Act] that an exchange of one security for another is a sale" 1 L. LOSS, *SECURITIES REGULATIONS* 513 (1961 ed.).

110. 15 U.S.C. § 77c(a)(9) (1976).

111. *Id.* § 77c(a)(10).

112. *Id.* § 77b(3).

STANDING TO SUE: PURCHASER OR SELLER OF SECURITIES

Securities ownership in the United States today is increasingly indirect ownership through pension funds, mutual funds or the like, rather than direct ownership by the individual investor. This indirect ownership may even take on a second level, as where fund managers turn over fund assets to an outside party, such as a bank, for investment. In *O'Brien v. Continental Illinois National Bank & Trust Co.*,¹¹³ the trustees of nine separate pension trust funds entered into agreements with CINB so that the latter would have sole responsibility and discretion in the investment of the various trust funds' assets. Acting pursuant to these agreements, CINB bought and sold stock of a number of companies of which CINB was also a substantial creditor.

The plaintiffs in *O'Brien* alleged that in some instances CINB received information as a creditor that was not available to the public and, at other times, CINB's role as creditor enabled it to affect dividend policies of the companies whose securities CINB was purchasing for the plaintiffs. Since these "conflicts of interest" were not disclosed to the plaintiffs, they sued CINB for violating section 10(b) of the Securities and Exchange Act¹¹⁴ and rule 10b-5,¹¹⁵ and included pendent state claims based upon breaches of fiduciary duty and contract.

The district court dismissed the plaintiffs' cases on the basis that they had no standing to sue under section 10 (b) and rule 10b-5 and found that plaintiffs were neither purchasers nor sellers of securities.¹¹⁶

The Seventh Circuit affirmed. The court found that the plaintiffs were not the purchasers of the securities bought in their behalf as beneficiaries of the trust by the trustee CINB. The court further stated that the purchaser in *O'Brien* was the CINB and that the section 10(b) and rule 10b-5 protected the CINB, not the plaintiffs. The holding was based upon the plaintiffs having given up all investment decisions to the bank. The court cited *Birnbaum v. Newport Steel Corp.*¹¹⁷ and *Blue Chip Stamps, Inc. v. Manor Drug Stores, Inc.*¹¹⁸ as precedent. In both cases, the plaintiffs were denied standing on the ground that they had neither purchased nor sold securities.

In *Birnbaum*, the plaintiff derivatively sued an officer and director

113. 593 F.2d 54 (7th Cir. 1979). Continental Illinois National Bank is hereafter referred to CINB.

114. 15 U.S.C. § 78j(b) (1976).

115. 17 C.F.R. § 240.10b-5 (1979).

116. 593 F.2d at 56-57. See 431 F. Supp. 292 (N.D. Ill. 1977).

117. 193 F.2d 461 (2d Cir.), cert. denied, 343 U.S. 956 (1952).

118. 421 U.S. 723 (1975).

of Newport Steel Corporation for violations of section 10(b) of the Securities Act of 1933. The officer had sold his Newport shares, which amounted to sale of the controlling interest, to another corporation for twice the market value of the shares. Birnbaum had neither bought nor sold securities during or after the officer's sale of the stock. He sued only as a stockholder. The Second Circuit denied Birnbaum standing under 10(b) and stated that section 10(b) was directed at the same type of misrepresentation usually associated with the purchase or sale of securities and not at fraudulent mismanagement of corporate affairs."¹¹⁹

Blue Chip Stamps involved an offeree who also sued on the basis of section 10(b). In *Blue Chip Stamps*, an offer of shares had been made because of an order to divest pursuant to antitrust litigation. The defendants had sent out prospectuses to certain offerees per that order. The plaintiff, an offeree, alleged that he had suffered a loss because he had not purchased stock pursuant to the offering due to the fact that the prospectus was overly pessimistic and therefore materially misleading. The Court denied the plaintiff standing under section 10(b) because he was neither a purchaser nor a seller. The Court then stated its twofold rationale for the limitation of standing under section 10(b). First, the Court intended to limit meritless litigation brought for settlement value only. Second, the Court believed that the proof of injury or the amount of injury for a nonpurchaser or nonseller was a best proof of hazy historical facts.¹²⁰

When the Seventh Circuit in *O'Brien* denied standing, the court cited *Blue Chip Stamps*. However, contrary to the facts of *Blue Chip Stamps*, in *O'Brien* there were purchases of securities and ascertainable damages. Thus, it appears that the Seventh Circuit based its decision to limit standing in *O'Brien* upon the Supreme Court's first rationale in *Blue Chip Stamps* of limiting all section 10(b) litigation. The court did so by defining purchaser as the party who makes the investment decision and not as the party on whose behalf the investment decision is made. The court stated:

[W]e are unable to say categorically that plaintiffs, on whose behalf [CINB] bought, were not in any sense purchasers of the securities. Nevertheless, we believe that considerations that helped to shape the decisions of the Supreme Court in *Santa Fe Industries, Inc. v. Green* . . . and *Blue Chip* as well, require the same result here, and that therefore a cause of action under Section 10(b) and Rule 10b-5 is not to be implied in the circumstances of this case.¹²¹

119. 93 F.2d at 464.

120. 421 U.S. at 743.

121. 593 F.2d at 66.

The court found that CINB rather than the plaintiffs made the decision and, therefore, were the protected parties under the rule.

The only power that the plaintiffs' retained over the defendant was the power to terminate the agreements with CINB at will, and plaintiffs did so terminate eventually. The plaintiffs in *O'Brien* alleged that they were induced not to exercise their powers of termination and that if they had known all the facts concerning CINB's relationship with the companies whose securities were being purchased, they would have made different trades. However, important facts material to the decision whether to terminate the trust agreements with CINB were considered by the court to be outside the penumbra of section 10(b), as defined by the Supreme Court in *Santa Fe Industries Inc. v. Green*,¹²² because the termination of the agreement was not a securities transaction. In addition, the Seventh Circuit in *O'Brien* reasoned that if the plaintiffs' contentions were upheld, then the court would be superimposing upon state fiduciary law a requirement that a trustee inform beneficiaries of the trust prior to the trustee's investment decision, a decision solely within the discretion of the trustee. This the *O'Brien* court declined to do.

Although the Seventh Circuit affirmed the district court's decision with regard to the federal securities laws' claims, the court reversed as to the pendent state claims.¹²³ The district court decision in *O'Brien* was based on the reasoning that the issues involved in the plaintiffs' case were moot and should be decided by the Illinois state courts.¹²⁴ The Seventh Circuit, however, found that such was not the case since the statute of limitations under Illinois law was running throughout the pendency of the federal district court litigation, which began in 1972.¹²⁵ The Seventh Circuit felt that it was an abuse of discretion also to dismiss the pendent state claims when plaintiffs would be subject to a motion to dismiss, likely to be granted, if the plaintiffs filed in state court.¹²⁶

In light of the holding in *Blue Chip Stamp*, the decision in *O'Brien* is clearly correct. It is interesting to note that but for *Blue Chip Stamps*, the Seventh Circuit would likely have decided *O'Brien* differently. Two years prior to *Blue Chip Stamps*, the Seventh Circuit decided *Ea-*

122. 430 U.S. 462 (1977).

123. 593 F.2d at 66.

124. *Id.* at 64.

125. The case had been reassigned to three separate judges during this time. Judgments were not entered until late in 1977. *Id.*

126. *Id.* at 64-65.

*son v. General Motors Acceptance Corp.*¹²⁷ and abolished the *Birnbaum* limitation on standing.¹²⁸ At the time *Eason* was decided, the court was not concerned that the holding would open flood gates to multitudinous and frivolous claims, thereby inundating an already over-worked federal courts system. In *Eason*, the Seventh Circuit preferred to define the appropriate limits of relief on a case-by-case basis using causal-nexus analysis.¹²⁹ Since the *Blue Chip Stamp* decision, however, courts throughout the country have become more conservative and have denied standing to sue in most cases.¹³⁰

CONCLUSION

The Seventh Circuit during 1978-79 was not presented with cases involving unusual or novel questions of securities law. Rather, the securities cases were of a traditional type and the Seventh Circuit used a conservative approach in deciding the cases. Much attention has been given to the recent decisions of the Supreme Court in which the Court has quite clearly expressed an attitude disfavoring the expansion of judicial remedies. The Seventh Circuit appears mindful of the fact that several of its decisions which have gone to the Supreme Court are now major decisions in the area of federal securities law. If the decisions of the Seventh Circuit during 1978-79 are indicative of the way that the court will hold in the future, then we will see little in the way of expansion in the area of federal securities law.

127. 490 F.2d 654 (7th Cir. 1973).

128. Prior to *Eason*, the Seventh Circuit appears to have followed the *Birnbaum* rule. See *Dasho v. Susquehanna Corp.*, 380 F.2d 262 (7th Cir.), *cert. denied sub nom.*, *Bard v. Dasho*, 389 U.S. 977 (1967).

129. For further discussion of the implications of *Blue Chip Stamp* on opinions decided by the Seventh Circuit, See 7 LOY-CHI. L. REV. 484 (1976).

130. *Fridrich v. Bradford*, 542 F.2d 307 (6th Cir. 1976), *cert. denied*, 429 U.S. 1053 (1977); *H.S. Equities, Inc. v. Fleet*, 420 F. Supp. 947 (S.D.N.Y. 1976); *Ruskary v. Levin*, [1976-77] FED. SEC. L. REP. (CCH) ¶ 95,842.