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Securities Law

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SECURITIES LAW

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In a term primarily noteworthy for its unusual quiet on the securities law front, the Seventh Circuit decided few important securities cases in 1981-82. In two very different cases, however, the court ventured into uncharted waters, with generally mixed results. Thus, in *Curtiss-Wright Corporation v. Helfand*,[1] the court addressed the power of a district court to exclude a class member from participation in a settlement fund because of an allegedly unique defense available against that class member. In *Chicago Board of Trade v. Securities and Exchange Commission*,[2] the court was called upon to decide whether the Securities and Exchange Commission had authority to regulate trading in options on Government National Mortgage Association certificates, given that the Commodities Futures Trading Commission had already assumed jurisdiction in the trading of futures in these securities.

This article will begin with an analysis of the *Curtiss-Wright* decision and will then briefly discuss the United States Supreme Court's review of a 1980 Seventh Circuit decision holding the Illinois Business Takeover Act unconstitutional.[3] Finally, two other securities opinions handed down by the Seventh Circuit during the 1981-82 term will be reviewed,[4] including one dealing with the emerging "sale of business"

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1. 687 F.2d 171 (7th Cir. 1982).
2. 677 F.2d 1137 (7th Cir.), *petition for review dismissed as moot*, 103 S. Ct. 434 (1982).
3. Mite Corp. v. Dixon, 633 F.2d 486 (7th Cir. 1980), *aff'd sub nom*. Edgar v. Mite Corp. 102 S. Ct. 2629 (1982).
4. Canfield v. Rapp & Son, Inc., 654 F.2d 459 (7th Cir. 1981); Trecker v. Scag, 679 F.2d 703 (7th Cir. 1982).

The Seventh Circuit decided several other securities cases which will not be discussed in this article. *See, e.g.*, Portnoy v. Texas Int'l Airlines, Inc., 678 F.2d 695 (7th Cir. 1982), a case involving the Securities Exchange Act of 1934, § 16(b), 15 U.S.C. § 78p(b) (1976), which prohibits insider trading and short-swing profits. The *Portnoy* court followed Reliance Elec. Co. v. Emerson Elec. Co., 404 U.S. 418 (1972) and Foremost-McKesson, Inc. v. Provident Securities Co., 423 U.S. 232 (1976), in holding that since liability under § 16(b) requires that the insider be the beneficial owner of a 10% interest in an issuing corporation's securities both at the time of the purchase and at the time of the sale, and since a person purchasing securities which put his holdings above the 10% level is not a 10% "beneficial owner" at the time of his limit-exceeding purchase, such a exception to federal securities law coverage.

DISAPPROVAL OF CLAIMS IN CLASS ACTION SETTLEMENTS

Curtiss-Wright Corporation v. Helfand

In an unusual case this past term the Seventh Circuit was called on to decide, apparently as a matter of first impression, the power of a district court to disapprove the claim of a class member for pro rata participation in a class settlement fund because of allegedly unique defenses available against that class member. In *Curtiss-Wright Corporation v. Helfand*,[5] a panel of the Seventh Circuit[6] held that the district court had the authority to disapprove such a claim under its general equitable powers over class action settlements.

Curtiss-Wright arose out of the notorious Cenco fraud,[7] in which Cenco, a company whose stock was listed on the New York Stock Exchange, created an inflated value for its stock by inflating the value of its inventories. When the fraud was exposed the stock price collapsed. Soon thereafter, a class action was brought in the district court in Chicago against Cenco and others on behalf of Cenco shareholders who had bought Cenco shares at inflated prices during the fraud and had seen their investments plummet. The suit, alleging violations of the federal securities laws and common law fraud, was certified as a class action under Federal Rule of Civil Procedure 23(b).[8] The class consisted of all purchasers of Cenco common stock during the period of the 1970-75 fraud.

person is not required to account to the corporation for any profit realized on the sale of these securities within six months of purchase. 678 F.2d at 697-98.

5. 687 F.2d 171 (7th Cir. 1982). The Seventh Circuit's holding regarding the district court's power to disapprove class members' claims has an important impact, not only in securities law but on class action settlements in general.

6. Judge Posner wrote the opinion for the unanimous panel which included Judge Bauer and Judge Swygert.

7. Other cases arising out of the Cenco fraud include Cenco, Inc. v. Seidman & Seidman, 686 F.2d 449 (7th Cir. 1982) (discussion of the standards under Illinois law governing the liability of Cenco's independent auditors for failing to detect the fraud by Cenco's management; upholding jury's finding that the auditors were not guilty of breach of contract, professional malpractice (negligence) and fraud); United States v. Read, 658 F.2d 1225 (7th Cir. 1981) (affirmance of criminal convictions of Cenco officers); SEC v. Cenco, Inc., 436 F. Supp. 193 (N.D. Ill. 1977) (SEC unsuccessfully sought injunction against future violations by Cenco pursuant to 15 U.S.C. § 77t(b) (1976) and 15 U.S.C. § 78u(e) (1976)); Helfand v. Cenco, Inc., 80 F.R.D. 1 (N.D. Ill. 1977) (certification of class action).

8. 687 F.2d at 172. Federal Rule of Civil Procedure 23(a) and (b) provides:

> **(a) Prerequisites to a Class Action.** One or more members of a class may sue or be sued as representative parties on behalf of all only if (1) the class is so numerous that joinder of all members is impracticable, (2) there are questions of law or fact common to the class, (3) the claims or defenses of the representative parties are typical of the claims

In 1974, before the fraud was publicly revealed, Curtiss-Wright began purchasing large amounts of Cenco stock. Within a few months it had acquired five percent of Cenco's outstanding stock and entered into negotiations with Cenco regarding a large loan to Cenco and possible acquisition of an even larger stock position.[9]

While it was considering increasing its position in Cenco, Curtiss-Wright's auditor was permitted to conduct a one-week business review of Cenco. Despite this review, which produced significant negative information not generally available to investors,[10] Curtiss-Wright continued buying Cenco stock until it had acquired some sixteen percent of the oustanding shares, making it by far the largest holder.[11] In the wake of the unmasking of the fraud, Curtiss-Wright used its dominant position to appoint three persons to Cenco's board, including Cenco's new chief executive officer. Consequently, when Curtiss-Wright found itself a member of the purchaser class in the class action litigation, it agreed with Cenco not to sue Cenco as a defrauded share purchaser other than as a passive class member.[12]

Upon learning that Curtiss-Wright had made substantial purchases subsequent to its discovery of the adverse information and had then used its shareholding position to name new board members

or defenses of the class, and (4) the representative parties will fairly and adequately protect the interests of the class.

(b) Class Actions Maintainable. An action may be maintained as a class action if the prerequisites of subdivision (a) are satisfied, and in addition:

(1) the prosecution of separate actions by or against individual members of the class would create a risk of

(A) inconsistent or varying adjudications with respect to individual members of the class which would establish incompatible standards of conduct for the party opposing the class, or

(B) adjudications with respect to individual members of the class which would as a practical matter be dispositive of the interests of the other members not parties to the adjudications or substantially impair or impede their ability to protect their interests; or

(2) the party opposing the class has acted or refused to act on grounds generally applicable to the class, thereby making appropriate final injunctive relief or corresponding declaratory relief with respect to the class as a whole; or

(3) the court finds that the questions of law or fact common to the members of the class predominate over any questions affecting only individual members, and that a class action is superior to other available methods for the fair and efficient adjudication of the controversy. The matters pertinent to the findings include: (A) the interest of members of the class in individually controlling the prosecution or defense of separate actions; (B) the extent and nature of any litigation concerning the controversy already commenced by or against members of the class; (C) the desirability or undesirability of concentrating the litigation of the claims in the particular forum; (D) the difficulties likely to be encountered in the management of a class action.

FED. R. CIV. P. 23(a) and (b).

9. 687 F.2d at 172.

10. *Id.* Curtiss-Wright's auditor found that Cenco had poor accounting controls, a low rate of inventory turnover, $10 million worth of obsolete inventory and inadequate quarterly reports. *Id.*

11. *Id.*

12. *Id.*

and the current chief executive officer, the class representatives moved to add Curtiss-Wright as a third-party defendant and to exclude it from the class.[13] While this motion was pending, plaintiffs obtained court approval of a settlement of the class claims against Cenco. The settlement contained a provision that Curtiss-Wright's pro rata share of the settlement be retained in an escrow account pending resolution of the motion to exclude it from the class.[14] Similar action was taken when settlements were approved first with the individual defendants and then with Cenco's accountants.[15] The district court then held that Curtiss-Wright should only participate in the settlement with respect to Cenco purchases that predated its business review, and refused to grant Curtiss-Wright an evidentiary hearing on the issue.[16] Curtiss-Wright appealed.[17]

In the Seventh Circuit Curtiss-Wright first argued that, since it was concededly a class member, having purchased Cenco stock during the relevant time period, the court below lacked the power to deny its timely filed claim to participate pro rata in the settlement fund. Alternatively, it argued that such a denial could be made only after an adversary determination of the alleged defense to its claim.[18] The Seventh Circuit unanimously rejected both arguments.[19] It viewed Curtiss-Wright's first argument as a challenge to the power of a district court to modify a settlement agreement over the objection of a class member. The court found this question not presented by the case before it since the settlements, as submitted to and approved by the court below, included an express reservation of the motion to exclude Curtiss-Wright from participation. Therefore, the court noted, Curtiss-Wright was on notice that it faced the possibility of being denied participation in the settlement fund and in fact had the right to exclude itself from the class or to object to the settlement thus structured, neither of which it chose to do.[20]

13. *Id.*

14. Answering Brief for Appellee at 6, Curtiss-Wright Corp. v. Helfand, 687 F.2d 171 (7th Cir. 1982).

15. The district court's approval of these settlements was affirmed by the Seventh Circuit in an unpublished order, Helfand v. Fromkin, No. 80-2091 (7th Cir. July 13, 1981).

16. 687 F.2d at 172-73.

17. *Id.* at 173.

18. *Id.* at 173-74.

19. *Id.* at 175.

20. *Id.* at 173. In passively accepting the settlement as proposed, Curtiss-Wright may have been influenced by its agreement not to sue Cenco except as a passive member of the class. The Seventh Circuit suggested that this agreement was to cure Curtiss-Wright's uneasiness at being, in a de facto sense, on both sides of the litigation—a member of the plaintiff class suing Cenco and Cenco's principal shareholder who had named present management. *Id.*

The reserved motion to exclude Curtiss-Wright from the settlement may more properly be analyzed as a motion to amend the class definition rather than to amend the settlement agreement as Curtiss-Wright argued.[21] Curtiss-Wright was within the literal language of the class as defined—all persons who purchased Cenco stock during the period of the fraud.[22] What the district court was in fact doing was considering a motion to redefine and limit the class to those who had bought stock in Cenco during the period of the fraud and who did not possess the adverse information which had been discovered by Curtiss-Wright in its business review. There is no doubt that under Federal Rule of Civil Procedure 23(c)(1) all class certifications are conditional and subject to modification at any time.[23] Further, it is not uncommon for classes to be defined in terms of those injured by the wrongdoing, as Curtiss-Wright had allegedly not been since it purchased with knowledge of the fraud.[24] The court quite properly left for another day the far more difficult question of the power of a court to modify the terms of a settlement either after or in the course of approval.[25]

The more difficult question is what sort of proceeding is required to determine whether a claimant is or is not a member of the class as redefined, which here would be all who purchased during the claim period and as to whom Cenco did not have a valid defense. Curtiss-Wright argued that judicial determination of the existence of a valid defense was required before such a class-membership determination could be made.[26] This argument was rejected by the Seventh Circuit.[27]

21. *Id.*

22. *Id.* at 172.

23. FED. R. CIV. P. 23(c)(1) ("An order under this subdivision [certifying a class] may be conditional, and may be altered or amended before the decision on the merits"). *See also* Social Services Union, Local 535 v. County of Santa Clara, 609 F.2d 944, 949 (9th Cir. 1979) ("If at any time before, during, or after trial it appears that for any reason the unions no longer fairly and adequately protect the interests of the class, class status may be withdrawn or appropriately modified"); Guerine v. J. & W. Investment, Inc., 544 F.2d 863, 864 (5th Cir. 1977) ("A decision as to class certification is not immutable. Rule 23(c)(1) empowers and requires a court to carefully scrutinize the adequacy of representation in all class actions"); Eovaldi v. First Nat'l Bank of Chicago, 71 F.R.D. 334, 335 (N.D. Ill. 1976) ("The certification can be amended at any time before a decision on the merits and, under some circumstances, even thereafter").

24. *See, e.g.*, Badillo v. Central Steel & Wire Co., 89 F.R.D. 140 (N.D. Ill. 1981); Edmondson v. Simon, 24 Fair Empl. Prac. Cas. (BNA) 1031 (N.D. Ill. 1978). *See also* Alliance to End Repression v. Rochford, 565 F.2d 975 (7th Cir. 1977), for a discussion of the propriety of defining a class in terms of those injured by defendant's wrongdoing.

25. Since approval of a class settlement under Federal Rule of Civil Procedure 23(e) turns on the court's determination that the settlement is fair and reasonable, Bryan v. Pittsburgh Plate Glass Co., 494 F.2d 799 (3d Cir.), *cert. denied sub nom.* Abate v. Pittsburgh Plate Glass Co., 419 U.S. 900 (1974), a post-approval modification of the class definition would seem to require new notice and another fairness determination, with a class member who would be excluded presumably having a chance to object and appeal.

26. 687 F.2d at 173-74.

The court first noted, in dicta, that if the test was as proposed by Curtiss-Wright, Curtiss-Wright would prevail, since Cenco did not have a good defense against Curtiss-Wright. It noted that at worst Curtiss-Wright was guilty of negligence in buying Cenco shares after obtaining information from which they should have discerned fraud and that negligence is not an affirmative defense to an intentional tort such as fraudulent misstatement.[28] While the court in this dicta followed earlier holdings of the Seventh Circuit and other courts,[29] it perhaps did not do justice to Cenco's potential defense against Curtiss-Wright. The case law seems reasonably clear that, at least in the case of affirmative misrepresentations and misstatements, reliance is a relevant element of a claim in a section 10b-5 action.[30] Allegedly, Curtiss-Wright had actual knowledge of the unfavorable state of Cenco's affairs. Thus, it is difficult to see how it could prevail, at least as to its post-business review purchases, in showing that it had relied on the false statements prepared by Cenco regarding inventory and other matters.[31]

Nonetheless, the Seventh Circuit concluded that the validity of Cenco's defense need not be determined. Rather, the court saw the question as one of relative equities between Curtiss-Wright and other

27. *Id.* at 174.

28. *Id.*

29. *See* Shores v. Sklar, 647 F.2d 462, 468-72 (5th Cir. 1981); Sundstrand Corp. v. Sun Chemical Corp., 553 F.2d 1033, 1040 (7th Cir. 1977) (failure to exercise due care or diligence is not an available defense in a Rule 10b-5 intentional fraud case); Holdsworth v. Strong, 545 F.2d 687 (10th Cir. 1976), *cert. denied*, 430 U.S. 955 (1977) (plaintiff in a 10b-5 case is not required to investigate the truth or falsity of an intentional misrepresentation unless it is patently false).

30. *See, e.g.*, Panter v. Marshall Field & Co., 646 F.2d 271, 283-84 (7th Cir. 1981), and cases cited therein. *See also* Panzirer v. Wolf, 663 F.2d 365, 367 (2d Cir. 1981), *vacated and dismissed as moot*, 103 S. Ct. 434 (1982); Shores v. Sklar, 647 F.2d 462, 468 (5th Cir. 1981). There is a dispute as to whether reliance need be proved initially by the plaintiff or whether it can be presumed, subject to rebuttal. Thus, in Affiliated Ute Citizens v. United States, 406 U.S. 128, 153-54 (1972), the Court held that in cases involving primarily a failure to disclose, "[a]ll that is necessary is that the facts withheld be material in the sense that a reasonable investor might have considered them important." This policy has been expanded by some courts to not require plaintiffs to affirmatively establish reliance in a 10b-5 action when material omissions occur in a fraud-upon-the-market situation. Helfand v. Cenco, Inc., 80 F.R.D 1, 8 (N.D. Ill. 1977), and cases cited therein. However, *Affiliated Ute* and subsequent cases did not abolish the reliance requirement, but rather established a rebuttable presumption of reliance where it is logical to assume that reliance in fact existed but would be unduly burdensome to prove, as in instances of non-disclosure. *E.g.*, Shores v. Sklar, 647 F.2d 462 (5th Cir. 1981). Unlike the situation envisioned in *Affiliated Ute*, this case concerns affirmative misrepresentations as well as omissions on Cenco's part. It is hardly logical to assume that Curtiss-Wright placed any reliance whatsoever in Cenco's inflated figures after it received the report from its auditors.

31. *See supra* note 10. The rest of the class, in contrast, argued that, in purchasing Cenco's shares at an inflated price, they indirectly relied on Cenco's misstatements since these statements had been taken into account by the market. Helfand v. Cenco, Inc., 80 F.R.D 1 (N.D. Ill. 1977). Such indirect proof of reliance in open market purchase cases is common. *See, e.g.*, Shores v. Sklar, 647 F.2d 462 (5th Cir. 1981), and cases cited therein. *See also* Panzirer v. Wolf, 663 F.2d 365 (2d Cir. 1981), *vacated and dismissed as moot*, 103 S. Ct. 434 (1982).

claimants to the class settlement fund.[32] Noting that the class device is equitable in origin, as is the process of allocating inadequate funds among competing claimants, the Seventh Circuit held that the district court's equitable powers permitted an equitable allocation of funds.[33] The court thus held that, as compared to the other claimants to the fund, who it assumed did not have inside knowledge as to the true state of affairs, Curtiss-Wright lacked equity and should take nothing on its post-business review purchases.[34]

The cases on which the Seventh Circuit relied for allocating shares in a settlement on the basis of an equitable balancing between claimants to a fund at most suggest that the district court, in administrating settlements, had broad, equitable discretion. No case, however, suggests that a chancellor has the power to determine summarily, and without an adversary determination of the disputed facts, such questions as the validity of Cenco's defense against Curtiss-Wright or Curtiss-Wright's relative equities as compared to the other claimants.[35] The fact that the balancing of equities is between competing claimants rather than a plaintiff and a defendant is not enough to deny Curtiss-Wright its due process right to a full factual presentation. In the closely analogous areas of equitable receiverships and challenges by claimants who are in the same class in bankruptcy proceedings, the same relationship between competing claimants to a limited res exists.[36] Yet it is

32. 687 F.2d at 174.

33. *Id. See also* Hansberry v. Lee, 311 U.S. 32 (1940). *See generally* CHAFEE, SOME PROBLEMS OF EQUITY 169-70, 223 (1950).

34. *Id.* at 175. There was no evidence on the record that any other class members knew or should have known of Cenco's fraudulent misstatements. However, the class representatives had apparently made no effort to determine whether any of the thousands of other class members, like Curtiss-Wright, had had access to the adverse information before purchasing.

35. Thus, the Seventh Circuit's reliance on Marshall v. Holiday Magic, Inc., 550 F.2d 1173, 1178-79 (9th Cir. 1977) and In re Equity Funding Corp. of America Securities Litigation, 603 F.2d 1353, 1364-65 (9th Cir. 1979), appears to be misplaced. In *Marshall*, the court was discussing the propriety of a settlement in which "each class member was offered 100% of the amount he paid." In *In re Equity Funding Corp. of America Securities Litigation*, the court was discussing the propriety of an offset provision in a settlement which applied equally to *all* debentureholders, an entire subset of claimants. Neither case even mentions a situation where the district court judge's discretion was being exercised to reduce the award of only one claimant, absent any factual hearing. For a more common approach to resolving disputed class members' claims in securities suits in which each disputed claim is examined on its facts, see Valente v. Pepsico, Inc., 89 F.R.D. 352 (D. Del. 1981). *See generally* Meites & Aborn, *Distributing the Settlement Fund in a Class Action*, 1980 A.B.A. Sec. Lit. vol. 7, no. 4, 33.

36. *See, e.g.*, Bankruptcy Rule 201 and Bankruptcy Act of 1978, § 502, 11 U.S.C. § 502 (Supp. V 1981). This procedure is also followed in common law receiverships, which are an equitable analogue to class action proceedings under Federal Rule of Civil Procedure 23. *See* Bankruptcy Rule 306(c); *Collier on Bankruptcy*, ¶ 502.01[2]-[3] (15th ed. 1979). *See also* Heyman v. Kemp (In re Teltronics, Ltd.), 649 F.2d 1236 (7th Cir. 1981) (receiver); Commodity Futures Trading Commission v. Probber Int'l Equities Corp., 504 F. Supp. 1154 (S.D.N.Y. 1981) (receiver).

clear, both in terms of the settled case law and the governing statutes and rules, that an objection to a claim is not to be resolved summarily or on the basis of relative equity when compared with other claims of the same class. Rather, such an objection should be decided with the usual procedural safeguards employed to determine the objective validity of the claim.[37] In suggesting that a district court can summarily deny claims to a class settlement under its general equitable powers, the court thus seems to have given less than adequate consideration to the due process considerations involved and to the established procedures in analogous equitable situations.[38]

STATE TAKEOVER LEGISLATION

Supreme Court Affirmance of Mite Corp. v. Dixon

In the 1980-81 term, the Seventh Circuit dealt with a case which raised the issue of the limits of state authority to regulate the takeover of publicly held corporations. In *Mite Corp. v. Dixon*,[39] the court held that the Illinois Business Takeover Act[40] was preempted under the Supremacy Clause of the Constitution because it conflicted with the Williams Act.[41] The Seventh Circuit further held that the Illinois Act violated the Commerce Clause because it substantially obstructed interstate commerce.[42]

The Illinois Act required that any takeover offer for the shares of a

37. This is not to say that a procedure short of an evidentiary hearing may not be appropriate in some cases. *See, e.g.*, Airlines Stewards v. American Airlines, Inc., 455 F.2d 101 (7th Cir. 1972); In re Calpa Products Co., 249 F. Supp. 71 (E.D. Pa. 1965).

38. In stressing that such action is necessitated by the compulsory nature of a class settlement, the court misses the point. While it is true that a class member who does not opt out can be forced to participate in a settlement under Federal Rule of Civil Procedure 23(b)(3), *see supra* note 8, such participation cannot be conditioned on a relinquishment of due process rights. *See, e.g.*, Eisen v. Carlisle & Jacquelin, 417 U.S. 156 (1974); Airline Stewards v. American Airlines, Inc., 455 F.2d 101 (7th Cir. 1972); Boggess v. Hogan, 410 F. Supp. 433 (N.D. Ill. 1975). Moreover, there is no conflict between due process and compulsory treatment, since a court that approves a settlement with a narrowly drawn class (i.e., all who were injured by the misstatements, all who relied, etc.) can then, consistent with due process, fashion objective, adversary procedures to adjudicate class membership and the right to participate in the settlement fund. Here, for example, the district court could have adjudicated the sole issue of the adequacy of the alleged defense, a relatively simple matter, as seen by the Seventh Circuit's summary disposition. 687 F.2d at 174.

39. 633 F.2d 486 (7th Cir. 1980), *aff'd sub. nom*. Edgar v. Mite Corp., 102 S. Ct. 2629 (1982). For a discussion of the Seventh Circuit's decision in *Mite Corp.*, see Collens, *Securities Law: Developments in Takeovers, Securities Fraud and Insider Trading in the Seventh Circuit*, 58 CHI.-KENT L. REV. 509, 521 (1982) [hereinafter cited as *Securities Law*].

40. ILL. REV. STAT. ch. 121½, §§ 137.51-.70 (1981) [hereinafter referred to as the Illinois Act].

41. 633 F.2d at 498. *See supra* note 51, and text accompanying notes 52-53 for a brief discussion of the Williams Act.

42. 633 F.2d at 502.

target company must be registered with the Illinois Secretary of State.[43] Section 137.57.E of the Illinois Act empowered the Illinois Secretary of State to pass upon the substantive fairness of a tender offer and to prohibit it from going forward if, in his opinion, the offer was "inequitable."[44] The Seventh Circuit held that the Illinois Act's approach to investor protection by "benevolent bureaucracy" was preempted by the conflicting approach of the Williams Act "which contemplates unfettered choice by well-informed investors."[45] The Seventh Circuit also found that other provisions of the Illinois Act conflicted with the Williams Act, since the Illinois Act provided that hearings on the takeover offer may be required and that a takeover offer must be filed twenty days before becoming effective.[46] The court found that these provisions might well result in unacceptable delay, which could enhance incumbent management's ability to defeat a tender offer, to the detriment of investors.[47] Further, the court held that because the Illinois Act substantially obstructed interstate commerce, without countervailing local benefit, it "violated the commerce clause."[48]

43. ILL. REV. STAT. ch. 121½, § 137.54.A (1981). The Seventh Circuit stated that:

> [T]he [Illinois] Act reaches every tender offer made for any corporation that meets, *inter alia*, two of the following conditions:
> (a) has its principal executive office in [Illinois];
> (b) is organized under the laws of [Illinois];
> (c) has at least 10% of its stated capital and paid-in surplus represented in [Illinois].
> Ill. Rev. Stat. ch. 121½, § 137.52-10 (1979). Thus, the Act grants jurisdiction to the Secretary of State over tender offers that would not affect a single Illinois shareholder.

633 F.2d at 501 (footnote omitted). The Act also applied to tender offers made for corporations for which 10% of the outstanding shares were held by Illinois residents. *Id.* at 501 n.27. *See* ILL. REV. STAT. ch. 121½, § 137.52-10 (1981). Section 137.52-9 of the Act defines "takeover offer" as "the offer to acquire or the acquisition of any equity security of a target company, pursuant to a tender offer." ILL. REV. STAT. ch. 121½, § 137.52-9 (1981). The terms "tender offer" and "takeover offer" are used interchangeably, and a "tender offer" is usually understood to mean "a publicly made invitation addressed to all shareholders of a corporation to tender their shares for sale at a specified price." Note, *The Developing Meaning of "Tender Offer" Under the Securities Exchange Act of 1934*, 86 HARV. L. REV. 1250, 1251 (1973).

44. 633 F.2d at 493. *See* ILL. REV. STAT. ch. 121½, § 137.57.E (1981).

45. 633 F.2d at 494.

46. *Id.* at 495. *See* ILL. REV. STAT. ch. 121½, § 137.54.E (1981).

47. 633 F.2d at 494-95. The Seventh Circuit concluded that:

> [T]he Illinois Act is preempted by the Williams Act because the former (1) tends inordinately to substitute regulatory control for investor autonomy, (2) provides for hearings the institution of which may be indirectly delegated to incumbent management and which are potentially interminable in length, (3) provides for other delays and mechanisms for delay which are potentially grossly in excess of the delay mandated by Congress and deemed by Congress to be appropriate to the protection of investors and (4) provides for lengthy prenotification delay, a requirement Congress specifically rejected.

Id. at 498-99.

48. *Id.* at 502.

In affirming the Seventh Circuit's decision, the United States Supreme Court[49] noted that because nothing in the Securities and Exchange Act of 1934 explicitly prohibits states from regulating takeovers,[50] and since it would be possible to comply with the provisions of both the Williams and Illinois Acts, the issue for consideration was whether the Illinois Act frustrated the objectives of the Williams Act in some substantial way.[51] The Court then noted that in imposing the requirements embodied in the Williams Act, Congress intended to protect investors, and that a "major aspect" of the congressional effort to protect investors was to avoid favoring either management or the takeover bidder.[52] Thus, the investor protection which Congress sought to embody in the Williams Act consisted not only of furnishing the necessary information to investors but also of "withholding from management or the bidder any undue advantage that could frustrate the exercise of an informed choice."[53] The Supreme Court agreed with the Seventh Circuit that there were three provisions of the Illinois Act that upset this congressional balance.[54] First, under the Illinois Act's required twenty-day precommencement notification period, the offeror could not communicate its offer to the target company's shareholders; the target company, however, was free to disseminate information on the impending offer to its own shareholders.[55] Second, the Illinois Act allowed either the Secretary of State or incumbent management to use the hearing provisions of the Act to delay a tender offer indefinitely.[56] Third, the Illinois Act allowed the Secretary of State to pass on the substantive fairness of a tender offer. The Secretary was required to deny the registration of a tender offer if the offer failed to provide full and fair disclosure to the offerees or if the Secretary determined that

49. Edgar v. Mite Corp., 102 S. Ct. 2629 (1982), *aff'g*, Mite Corp. v. Dixon, 633 F.2d 486 (7th Cir. 1980).

50. In fact, § 28(a) of the 1934 Act provides, in pertinent part:

> Nothing in this chapter shall affect the jurisdiction of the securities commission (or any agency or officer performing like functions) of any State over any security or any person insofar as it does not conflict with the provisions of this chapter or the rules and regulations thereunder.

Securities Exchange Act of 1934, § 28(a), 15 U.S.C. § 78bb(a)(1976).

51. 102 S. Ct. at 2635. "The Williams Act, passed in 1968, was the congressional response to the increased use of cash tender offers in corporate acquisitions, a device that had 'removed a substantial number of corporate control contests from the reach of existing disclosure requirements of the federal securities laws.'" *Id.* at 2635-36 (citation omitted).

52. *Id.* at 2636.

53. *Id.* at 2636-37.

54. *Id.* at 2637.

55. *Id.* at 2637-38. The Williams Act does not contain a pre-commencement notification provision. *Id.* at 2637-38 and n.11.

56. *Id.* at 2638-39 and n.13.

the offer was inequitable.[57] The legislative history of the Williams Act, however, indicated that Congress left the determination of the fairness of a tender offer to the discretion of the investor.[58] The Court further held that the Illinois Act was invalid under the Commerce Clause. When the more stringent terms of the Illinois Act were not satisfied, the Act directly regulated and prevented interstate tender offers thus inhibiting interstate transactions. Consequently, the Illinois Act imposed a substantial burden on interstate commerce which outweighed the local interest which it purported to further.[59]

The Supreme Court's affirmance of the Seventh Circuit indicates that the proliferation of state takeover statutes, many of them similar to the Illinois Act[60]—with its tilt in favor of incumbent management and its adoption of "big-brother" protectionism as opposed to the informed free-choice decision-making by investors which Congress envisioned when it passed the Williams Act—may be an unconstitutional interference with federal regulation of securities. The Court affirmed the Seventh Circuit's finding that the Illinois Act imposed a significantly increased burden on interstate commerce in an area where Congress did not intend it, and this decision will presumably discourage other state attempts to regulate takeover offers.

SECURITIES FRAUD

Section 10(b) of the Securities Exchange Act of 1934 (SEA)[61] and

57. *Id.* at 2639 and n.15. *See generally* ILL. REV. STAT. ch. 121½, § 137.54.E (1981).

58. *Id.* at 2639-40.

59. 102 S. Ct. at 2640. In holding that the Illinois Act directly regulated interstate commerce, the Court stated that:

> Mite's offer to Chicago Rivet's shareholders [for their stock] necessarily employed interstate facilities in communicating its offer, which, if accepted, would result in transactions occurring across state lines. These transactions would themselves be interstate commerce. Yet the Illinois law, unless complied with, sought to prevent Mite from making its offer and concluding interstate transactions not only with Chicago Rivet's stockholders living in Illinois, but also with those living in other states and having no connection with Illinois.

Id. at 2641. Further, the Court found that while Illinois had a legitimate interest in protecting resident security holders, this interest was insufficient to outweigh the burden which the Illinois Act imposed on interstate commerce. *Id.* at 2642. *See generally* Pike v. Bruce Church, Inc., 397 U.S. 137, 142 (1970).

60. More than two-thirds of the states have enacted legislation similar to the Illinois Act. *See* SECURITIES LAW, *supra* note 26, at 523 n.119 (citing Fogelson, Wenig & Friedman, *Changing the Takeover Game: The Securities and Exchange Commission's Proposed Amendments to the Williams Act*, 17 HARV. J. ON LEGIS. 409, 441 (1980)).

61. Section 10(b) provides:

Rule 10b-5,[62] promulgated by the Securities and Exchange Commission (SEC),[63] prohibit fraud in connection with the purchase and sale of securities. During the 1981-82 term, the Seventh Circuit decided two section 10(b) cases. One case clarified the continuing discussion of the definition of a "security" while the other addressed questions of materiality, scienter and the statute of limitations.

Canfield v. Rapp & Son, Inc.

In *Canfield v. Rapp & Son, Inc.*,[64] the Seventh Circuit addressed the question of whether the sale of a business, through the sale of all of its stock, constituted the sale of a "security." Relying on its earlier decision in *Frederiksen v. Poloway*,[65] the Court held that such a transaction did not fall within the definition of a "security" and thus furthered the emerging "sale of business" exception to Rule 10b-5.[66]

The controversy in *Canfield* began when Rapp & Son, Inc., purchased all of the outstanding shares of stock of the Twigg Corporation from its three owners, one of whom was Canfield. After the transaction, Canfield sued to enforce a provision of the sales agreement[67] and Rapp counterclaimed,[68] alleging that the sale violated both federal

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange—
>
> . . . .
>
> (b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe. . . .

Securities Exchange Act of 1934, § 10(b), 15 U.S.C. § 78j(b) (1976).

62. Rule 10b-5 provides:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,
>
> (a) To employ any device, scheme, or artifice to defraud,
>
> (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
>
> (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

17 C.F.R. § 240.10b-5 (1982).

63. *See* 15 U.S.C. § 78d(a)(1976) (established the SEC); 15 U.S.C. § 78w(a)(1976) (gives the SEC the power to promulgate rules and regulations).

64. 654 F.2d 459 (7th Cir. 1981).

65. 637 F.2d 1147 (7th Cir.), *cert. denied*, 451 U.S. 1017 (1981). For a discussion of the Seventh Circuit's decision in *Frederikson*, see *Securities Law*, *supra* note 39, at 533.

66. 654 F.2d at 460.

67. *Id.* at 462 n.3.

68. Canfield's original claim became moot, and only Rapp's counterclaims were tried by the district court. *Id.*

and Indiana securities law and also constituted common law fraud.[69] Specifically, Rapp alleged that during negotiations Canfield misrepresented the status of government equipment leased by Twigg from the United States Air Force,[70] and that Rapp relied on Canfield's misrepresentations and omissions as to this equipment when it negotiated the agreement to buy Twigg.[71] The Seventh Circuit affirmed the district court's finding that Rapp had failed to establish the material elements of a federal or state securities law claim.[72] The court further upheld the district court's finding that Canfield's alleged misrepresentation did not give rise to a common law fraud action under Indiana law.[73] Finally, the Seventh Circuit agreed that, under the circumstances, the transaction was not a sale of a "security" for securities law purposes.[74]

The Seventh Circuit affirmed based on its decision in *Frederiksen*.[75] In *Frederiksen*, plaintiffs purchased both the assets and the stock in defendant's corporation and subsequently sued the sellers under the federal securities laws, alleging fraudulent misrepresentations.[76] The Seventh Circuit held that although in form the sale was a sale of securities and thus literally within the language of section 10(b) and Rule 10b-5, the transaction in *Frederiksen* was not covered by the federal securities laws.[77] In so holding, the court relied on the "economic reality" test enunciated by the United States Supreme Court in *United Housing Foundation, Inc. v. Forman*,[78] which requires that three elements be present in order for an instrument to qualify as a security:

69. *Id.* at 461.
70. *Id.* at 461-62.
71. *Id.* at 462.
72. *Id.* at 462, 468.
73. *Id.* at 463, 468.
74. *Id.* at 462-63, 465-66. In defining "security," the Seventh Circuit stated:

> Section 2 of the Securities Act of 1933, 15 U.S.C. § 77(b) defines "security" as follows:
>
> > When used in this subchapter, unless the context otherwise requires—
> >
> > (1) *The term "security" means any note, stock*, treasury stock, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, or, *in general, any interest or instrument commonly known as a "security"*, or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing.
>
> The definition of "security" in the Securities Exchange Act of 1934, 15 U.S.C. § 78c(a)10 is substantially the same. The two definitions are considered functional equivalents. *Tcherepnin v. Knight*, 389 U.S. 332, 335-36 (1967).

Id. at 463 n.5 (emphasis added). *See also* Securities Act of 1933, § 2, 15 U.S.C. § 77(b)(1976).

75. Frederiksen v. Poloway, 637 F.2d 1147 (7th Cir.), *cert. denied*, 451 U.S. 1017 (1981).
76. *Id.* at 1148-49.
77. *Id.* at 1150-51.
78. 421 U.S. 837 (1975).

"(1) an investment in a common venture; (2) premised on a reasonable expectation of profits; (3) to be derived from the entrepreneurial or managerial efforts of others."[79] In *Frederickson*, the plaintiffs' purchase did not satisfy the first and third elements of the *Forman* test and so the transfer of an entire business, although in form the sale of stock, did not involve the purchase or sale of a "security."[80]

Similar to its holding in *Frederiksen*, the *Canfield* court held that Rapp's purchase of Twigg Corporation failed to satisfy two elements of the economic reality test. It did not satisfy the first element, investment in a common venture, because this requires a "sharing or pooling of funds."[81] Since Rapp purchased all the Twigg Corporation stock, there was no sharing or pooling of funds.[82] The third element of the test—that profits be derived from the efforts of others—was also not satisfied because Rapp took over management and control of Twigg.[83]

Rapp attempted to distinguish *Frederiksen* in two ways. First, he argued that the economic reality test should not apply if a transaction involves "stock" that has all the attributes of ordinary common stock, since such stock is clearly within the definition of a "security."[84] He further argued that the *Forman* analysis should be applicable only to transactions that do not fall clearly within the definition of a "security."[85] Rapp thus concluded that, because the stock he purchased had all the attributes of ordinary common stock, he should not be required to satisfy the economic reality test before gaining the protection of the securities laws.[86] The court rejected this argument and reaffirmed its holding in *Frederiksen* that " 'economic reality' is always the key issue."[87] Rapp next argued that *Frederiksen* involved a simultaneous sale of assets and stock and that the decision focused primarily on the

79. 637 F.2d at 1152 (citing United Housing Found., Inc. v. Forman, 421 U.S. 837, 852 (1975)).

80. 637 F.2d at 1152.

81. 654 F.2d at 463-64.

82. *Id.* at 464.

83. *Id.*

84. *Id.* *See supra* note 74 for the definition of a security. The stock in *Frederiksen*, unlike that in *Canfield*, was owned by a sole shareholder, and thus arguably did not have the attributes of ordinary common stock. For a possible conflict in the case law of the Seventh Circuit, see McGrath v. Zenith Radio Corp., 651 F.2d 458, 467-68 n.5 (7th Cir. 1981).

85. 654 F.2d at 464. Rapp's argument was based on the approach taken by the Fourth Circuit in Coffin v. Polishing Machines, Inc., 596 F.2d 1202, 1204 (4th Cir.), *cert. denied*, 444 U.S. 868 (1979). The Seventh Circuit in *Canfield* rejected the *Coffin* court's analysis. 654 F.2d at 465. *But see* Golden v. Garafalo, 678 F.2d 1139 (2d Cir. 1982) (the Second Circuit, in a two to one decision, refused to recognize a "sale of business" exception).

86. 654 F.2d at 464.

87. *Id.* at 465.

sale of the business assets rather than the stock.[88] In the *Canfield* transaction, however, only stock was involved. Thus, Rapp argued that the predominance of the asset sale in *Frederickson* was the key indication that what was being sold was a business, rather than securities.[89] The court was not persuaded by this reasoning. It stated that "to find that a sale of 100% of the stock brings the transaction within the securities laws, while a sale of assets plus 100% of the stock does not, would exalt form over substance."[90] The court noted that while the stock purchased by Rapp had the characteristics of ordinary stock in Rapp's hands—the right to vote and receive dividends—this stock was not ordinary capital stock because Rapp acquired total control over dividends and voting.[91] As the court stated, "When a purchaser acquires 100% of the stock of a corporation and, therefore, for example, can confer dividends on itself at will, the fact that dividends are a characteristic of ordinary capital stock does not give rise to a justifiable assumption that the federal securities laws apply."[92]

The appeal of the economic reality test, as applied by the Seventh Circuit, for determining what constitutes a "security" is twofold: (1) its simplicity,[93] and (2) its exclusion from the federal courts of disputes

88. *Id.*

89. The court described the factual difference as follows:

> In *Frederiksen*, the purchase price of the corporate assets was over $190,000. An escrow fund was established with $160,000 of the assets purchase price in order to satisfy the liabilities of the selling corporation. A separate stock purchase and voting trust agreement provided that defendant would sell 10% of his stock for $10 and, for an additional $10, would transfer his remaining 90% of the corporation's stock into a voting trust controlled by the buyer-plaintiff. The stock in the voting trust was to be redeemed by the selling corporation from the remainder of the $160,000 escrow fund left after satisfying the corporation's debts.
>
> Rapp argues that, in *Frederiksen*, the predominance of the asset sale was the key indicator of the sale of a business, rather than a sale of securities. Here, however, the transaction involved only the sale of stock. Here, the parties labeled their contract an "Agreement for Sale of Stock of Twigg Corporation." Pursuant to the Agreement, Rapp purchased 100% of the capital stock of Twigg, not Twigg's assets.

Id.

90. *Id.* at 465-66. The court held:

> The economic reality test requires us to look beyond the parties' method of structuring the transaction. There is no doubt that when Rapp purchased 100% of the Twigg stock, Rapp purchased the entire business. A separate sale of assets would have added nothing to the economic reality of the transaction.

Id. at 466.

91. *Id.* at 466 n.7. Such a result is true whenever one entity acquires all the stock of another, whether in a single purchase or seriatim. Under a seriatim purchase, the acquisition of the balance of the stock would not be a purchase of securities, even though all the preceding purchases apparently would be—an anomalous result.

92. *Id.*

93. One cannot help but speculate, however, upon future factual scenarios. If, for example, Rapp had a co-buyer of even a small portion of the Twigg stock, the transaction would apparently have been found by the Seventh Circuit to be covered by the securities laws. *But see* Sutter v. Groen, 687 F.2d 197 (7th Cir. 1982), discussed *infra* note 94. Further, the definition of a "secur-

arising out of the acquisition of small corporations by a single purchaser. There is, however, no "small business" or "single buyer" exception in the federal securities laws and the rule emerging in the Seventh Circuit should be watched with interest, both for its reception in other circuits and for possible resolution by the Supreme Court of the emerging conflict between circuits.[94]

Trecker v. Scag

In a case which is of interest primarily because of Judge Posner's concurrence, a panel of the Seventh Circuit[95] reversed the district court's grant of summary judgment in *Trecker v. Scag*.[96] In August, 1979, Thomas Trecker filed suit, under Section 10(b) of the SEA[97] and Rule 10b-5,[98] against Dane Scag, his former business associate; Wisconsin Marine, Inc. (WMI), the business they had founded together; and Ransomes, Sims and Jefferies, Ltd. (Ransomes), a British corporation that had purchased a 34.1% interest in WMI in the summer of 1978.[99]

When Trecker and Scag went into business together and formed WMI, with Scag contributing sixty percent and Trecker forty percent of

ity" in such circumstances depends on the characteristics which the stock will have in the hands of the buyer after the transaction, as opposed to its characteristics before the sale.

94. *Compare Canfield, Frederiksen and* King v. Winkler, 673 F.2d 342 (11th Cir. 1982) *with* Golden v. Garofalo, 678 F.2d 1139 (2d Cir. 1982) *and* Coffin v. Polishing Machines, Inc., 596 F.2d 1202 (4th Cir.), *cert. denied*, 444 U.S. 868 (1979). In rejecting *Frederiksen*, the Second Circuit in *Golden* pointed out that the Supreme Court treats the determination of whether a particular instrument is a "security" as one which does not vary from time to time depending on the holdings of the parties or their intentions regarding a particular transaction. The "sale of business" exception, however, treats instruments as "securities" for some purposes but not for others. 678 F.2d at 1143-44.

The Seventh Circuit reconsidered the "sale of business" doctrine in Sutter v. Groen, 687 F.2d 197 (7th Cir. 1982), in light of the Second Circuit's rejection of it in *Golden*, and the Supreme Court's intervening decision in Marine Bank v. Weaver, 102 S. Ct. 1220 (1982). In a unanimous opinion, again authored by Judge Posner, the court in *Sutter* reaffirmed that the sale of an entire business to a single purchaser is not a sale of a "security" for purposes of federal law, "even if it is accomplished by a sale of stock or other securities," 687 F.2d at 189. The Seventh Circuit further adopted a new presumption for cases where a purchaser has acquired more than 50% but less than 100% of the stock of a corporation. In such cases, the court established a rebuttable presumption that the buyer purchased the stock for purposes of "entrepreneurship" rather than investment. Thus, unless the purchaser can show that his main purpose was investment, he will be held not to have purchased a "security." *Id.* at 203. This expansion of the 100% purchase doctrine enunciated in *Frederiksen* and *Canfield* occurred too late for detailed discussion in this article, but certainly increases the likelihood of eventual Supreme Court review of the "sale of business" doctrine.

95. Judges Cummings, Swygert and Posner.
96. 679 F.2d 703 (7th Cir. 1982).
97. *See supra* note 61.
98. *See supra* note 62.
99. 679 F.2d at 704.

the capital, they agreed to a stock redemption plan.[100] In December, 1973, Trecker asked to be bought out under the terms of the agreement, but WMI claimed it had insufficient funds with which to honor the redemption request. In 1976, Trecker sued in state court seeking specific performance of the redemption agreement or, in the alternative, the dissolution of the corporation.[101] In February, 1978, the state court held that Trecker was entitled to specific performance and, in a separate hearing in May, 1978, his stock was valued as of December 31, 1976, at $160,845.[102]

While the state court action was pending, Scag initiated negotiations to sell WMI to Ransomes. The deal, in which Ransomes agreed to provide a total of $624,176 in exchange for a 34.1% interest in WMI, was finalized in the spring of 1978.[103] Trecker had no actual knowledge of the WMI-Ransomes negotiations during his state court action because the state court had refused to allow Trecker any discovery as to the terms of the WMI-Ransomes deal. This refusal was made despite Trecker's argument that the agreement was relevant to his contention that his WMI stock should be valued as of the actual tender.[104] Consequently, on June 28, 1978, WMI paid $160,845 plus interest to Trecker for his 34.1% interest pursuant to the state court judgment ordering specific performance. Two days later, on June 30, 1978, WMI sold the 34.1% interest to Ransomes for $624,176.[105]

In July, 1979, Trecker received a copy of Ransomes' annual report, which disclosed the purchase of a 34.2% interest in WMI.[106] Trecker then filed his 10b-5 suit in federal court alleging that the defendants

100. *Id.*
101. *Id.*
102. *Id.* at 705.
103. *Id.* The state court opinion finding Trecker entitled to specific performance was issued on February 21, 1978. The WMI-Ransomes letter of intent was signed three days later, on February 24, 1978.

The final terms of the WMI-Ransomes deal provided that:

1) Trecker's stock must be fully redeemed as a precondition.
2) Ransomes would pay $124,176 toward redeeming Trecker's stock, would make a $500,000 contribution to WMI capital, would receive shares equalling 34.1% of WMI and Scagg would issue no additional WMI shares so that Ransomes' interest would not be deleted.
3) Ransomes had until September of 1979 to either exercise its option for the balance of WMI shares or to cancel and have the $624,176 refunded.
4) Scagg would continue as president of WMI for five years. *Id.*

104. *Id.* at 705-06.
105. *Id.* at 706. In September, 1979, Ransomes exercised its option to acquire the balance of WMI stock. *Id.*
106. *Id.* After the conclusion of the state trial, Trecker continually sought to ascertain the terms of the WMI-Ransomes agreement. When his various inquiries proved unsuccessful, Trecker was forced to purchase shares of Ransomes' stock in order to obtain Ransomes' annual report. *Id.*

had failed to disclose, and later misrepresented, facts regarding the WMI-Ransomes deal. He further contended that these facts would have altered his decision to sue in state court to have his shares redeemed.[107] The Wisconsin district court granted the defendants' motion for summary judgment on the basis that Trecker's suit was time-barred, and that the non-disclosure was neither material nor deliberate.[108] The Seventh Circuit unanimously reversed the Wisconsin district court's grant of summary judgment and remanded the case for further proceedings.[109]

The Seventh Circuit stated that because Section 10(b) and Rule 10b-5 have no federal statute of limitations, state statutes of limitations are controlling.[110] However, federal principles of equitable tolling determine when the limitations period begins to run.[111] The Wisconsin statute provides its own tolling requirement: suit must be brought within three years or before "the expiration of one year after the discovery of the facts constituting a violation, whichever first expires."[112]

The Seventh Circuit held that the federal tolling doctrine was applicable in this case to supply a "federal gloss" to the Wisconsin court's interpretation of the term "discovery."[113] The court ultimately held that the record did not permit the district court to hold that Trecker knew of the Rule 10b-5 violations at the time of the state court hearing in June, 1978,[114] and remanded.[115]

The Seventh Circuit also disagreed with the district court's findings that the requirements of materiality and scienter were not satisfied.[116] However, in an effort to focus the issue on remand, the court pointed out that what Trecker was alleging was that if he had known of Ransomes' negotiations during the pendency of his redemption suit, he

107. *Id.* at 704.
108. *Id.*
109. *Id.* at 710.
110. *Id.* at 706.
111. *Id.*
112. *Id.* (citing WIS. STAT. ANN. § 551.59(5) (1982)).
113. 679 F.2d at 706-08 and n.7.
114. *Id.* at 707-08. Throughout the state court proceedings, Trecker continued to attempt to discover the details of the WMI-Ransomes deal. Trecker's understanding of the contract was that Ransomes was to make a $500,000 contribution to capital and pay only $124,176 for his shares of stock. Even though he suspected that the sale to Ransomes had been put off until he was locked into the redemption action so that his shares could be sold to Ransomes for substantially more than he was paid for them, he could demonstrate no harm from the sale because he was paid $160,000 for his shares. *Id.* at 706.
115. The Seventh Circuit found that the statute of limitations was not tolled until Trecker acquired Ransomes' annual report in July of 1979. Thus, Trecker's suit, filed in the federal district court in August of 1979, was timely. *Id.* at 708.
116. *Id.* at 708-10.

would have abandoned the suit and held on to his shares.[117] The court stated that if Trecker could have dismissed his complaint under Wisconsin law, "then neither materiality nor scienter is precluded and he has stated a claim under Rule 10b-5."[118]

Judge Posner's concurrence was written "only to express my doubts whether this case really belongs in the federal courts. I do not mean that we do not have jurisdiction; I mean that perhaps we should not have jurisdiction."[119] The judge pointed out that Wisconsin is the home of all of the disputants except Ransomes, and that WMI was a closely held corporation whose stock was not freely traded. Thus, "the basis of federal jurisdiction over the lawsuit is Scag's use of the mails in his dealings with Ransomes, but the federal government has no substantive interest in local transactions just because the parties happen to send letters to each other."[120] Judge Posner argues that this case was one of common law fraud, a matter of state rather than federal law, and that, in any event, Wisconsin has a statute similar to Rule 10b-5.[121] Posner's contention was that Congress, in enacting section 10(b) of the Securities Exchange Act,[122] did not intend the federal courts to become involved in deciding "a garden-variety squabble among shareholders in a closely held corporation."[123] The judge characterized federal court jurisdiction in these circumstances as "the unintended result of administrative and judicial actions that have pushed the federal courts into an area that a proper conception of federalism would assign to state legislatures and judges."[124]

While this characterization of the *Trecker* suit as a "garden-variety squabble" may be accurate, Judge Posner cites no legislative history which would lead one to conclude that Congress did not intend the federal courts to exercise jurisdiction in such disputes. There is some merit to Judge Posner's feeling that this case "wasted" the time of the Seventh Circuit.[125] Yet there is considerable merit in developing a uniform body of federal law in securities cases—even in "garden variety"

117. *Id.* at 709.
118. *Id.* at 709-10. The Seventh Circuit stated that "The defendants conceded as much at oral argument." *Id.* at 709.
119. *Id.* at 710 (Posner, J., concurring).
120. *Id.*
121. *Id.*
122. *See supra* note 61.
123. 679 F.2d at 711.
124. *Id.*
125. *Id.* at 710. This same feeling may be at work in the Seventh Circuit's emerging doctrine under *Frederiksen* and *Canfield*, which refuses to hear disputes under the federal securities laws that arise out of the sale of small businesses that happen to be incorporated. *See supra* notes 64-94 and accompanying text.

ones—so that buyers and sellers throughout the nation can be assured of uniform obligations of full and fair disclosure which are enforceable in the federal courts. Indeed, the potential buyer of a closely held corporation who cannot predict in advance whether the representations he is receiving are covered by the federal securities laws may not be as willing to purchase or will insist on some sort of representation discount—surely an economically undesirable result.[126] Further, for the federal courts to determine what constitutes a "garden variety" securities case before trial would take nearly as much time as actually trying the case itself. Without direct action by Congress or the Supreme Court, the situation is not likely to change.

126. This is analogous to complaints about fraud, misrepresentation and other illegal acts in markets that are exempt from federal securities law jurisdiction. *See* Chicago Bd. of Trade v. SEC, 677 F.2d 1137 (7th Cir. 1982), *petition for review dismissed as moot*, 103 S. Ct. 434 (1982), where, in urging a regulated options market in Government National Mortgage Association certificate futures, mortgage lenders and others in the industry complained that the unregulated market had largely dried up because of fraud and uncertainty.

NOTES
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