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## Securities Law

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## SECURITIES LAW

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The Court of Appeals for the Seventh Circuit has been involved in many important decisions in the securities law area and the 1975-1976 term was no exception. During the term two Seventh Circuit securities cases were decided by the United States Supreme Court and two others were directly affected by Supreme Court decisions. This article will describe what the authors believe are the most significant developments in the area of securities law which occurred in the Seventh Circuit during the last term. The major topics to be covered include scienter and materiality in cases involving the anti-fraud sections of the Securities Exchange Act of 1934, particularly sections 10(b) and 14(e), liability under section 16(b) of the 1934 Act, the so-called short swing profits section, the definition of the terms "security" and "sale" under both the 1934 Act and the Securities Act of 1933 and the application of the statute of limitations in securities cases.

### SECTION 10(b) AND RULE 10b-5: SCIENTER

The Supreme Court's decision in *Ernst & Ernst v. Hochfelder*,<sup>1</sup> reversing a 1974 opinion of the Seventh Circuit,<sup>2</sup> was perhaps the Court's most significant decision in the securities field during the last term. In a six to two opinion by Justice Powell, the Court held that a private cause of action for damages under section 10(b) of the Securities Exchange Act of 1934<sup>3</sup> and rule 10b-5 thereunder,<sup>4</sup> could not be maintained in the absence of an allegation of "scienter," defined by the Court to mean "a mental state embracing intent to deceive, manipulate or defraud."<sup>5</sup>

The case involved a claim by plaintiffs that the president of a Chicago brokerage house (which was a member of the Midwest Stock Exchange)

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1. 425 U.S. 185 (1976).

2. 503 F.2d 1100 (7th Cir. 1974). See discussion of the Seventh Circuit's opinion in Fishman, *Securities Law*, 51 CHI.-KENT L. REV. 549, 556-59 (1974).

3. 15 U.S.C. § 78j(b) (1970) [hereinafter referred to in the text as the 1934 Act].

4. 17 C.F.R. § 240.10b-5 (1976).

5. 425 U.S. at 193-94 n.12.

induced them to invest in "escrow accounts," which were to bear a high rate of interest. After the president's suicide it was discovered that the firm was insolvent and the "escrow accounts" were spurious, the president having converted the funds invested therein to his own use. In an earlier opinion the Seventh Circuit found that the president's activities violated section 10(b) and rule 10b-5 and that the firm was also liable as an aider and abettor.<sup>6</sup> Unable to recover their losses from the insolvent firm and having failed in an action against the Midwest Stock Exchange,<sup>7</sup> the escrow account investors filed suit against Ernst & Ernst, charging them with negligently auditing the books of the brokerage firm. Plaintiffs argued that if Ernst & Ernst had conducted a proper audit the fraudulent nature of the escrow accounts would have been discovered.<sup>8</sup>

In determining whether a violation of section 10(b) had occurred, the Seventh Circuit adopted a "flexible standard of liability"<sup>9</sup> which could be molded to fit the peculiarities of every section 10(b) case:

a claim for aiding and abetting is made on demonstrating: (1) that the defendant had a duty of inquiry; (2) the plaintiff was a beneficiary of that duty of inquiry; (3) the defendant breached the duty of inquiry; (4) concomitant with the breach of duty of inquiry the defendant breached a duty of disclosure; and (5) there is a causal connection between the breach of duty of inquiry and disclosure and the facilitation of the underlying fraud; that is, adequate inquiry and subsequent disclosure would have led to the discovery of the underlying fraud or its prevention.<sup>10</sup>

Judge Swygert, writing for the majority, found that Ernst & Ernst had a statutory duty under section 17(a) of the 1934 Act<sup>11</sup> and rule 17a-5 thereunder<sup>12</sup> to conduct its audit in accordance with "generally accepted auditing standards" and that if Ernst & Ernst had breached its duty by conducting a negligent audit, it could be held liable as an aider and abettor under section 10(b) and rule 10b-5 even though it did not participate in or have knowledge of the principal party's fraudulent conduct.<sup>13</sup>

The Supreme Court reversed. It rejected the notion that liability could attach under section 10(b) and rule 10b-5 in the absence of proof of scienter. The Court thought that the use, in section 10(b), of the words "manipulative or deceptive" in conjunction with "device or contrivance" "strongly

6. SEC v. First Sec. Co., 463 F.2d 981, 986, 988 (7th Cir.), *cert. denied*, 409 U.S. 880 (1972).

7. Hochfelder v. Midwest Stock Exch., 503 F.2d 364 (7th Cir.), *cert. denied*, 419 U.S. 875 (1974).

8. Hochfelder v. Ernst & Ernst, 503 F.2d 1100, 1104 (7th Cir. 1974).

9. *Id.*

10. *Id.*

11. 15 U.S.C. § 78q(a) (1970).

12. 17 C.F.R. § 240.17a-5 (1976).

13. 503 F.2d at 1108.

suggest[s] that section 10(b) was intended to proscribe knowing or intentional misconduct.”<sup>14</sup> The Court found support for this conclusion in the scant legislative history of section 10(b) and in a comparison of other sections of the securities acts where Congress clearly specified the standard for liability.<sup>15</sup>

By focusing on an analysis of the language of the section and rule, the Court rejected the approach advocated by the Securities and Exchange Commission and adopted by Justice Blackmun in his dissent which would look to the effect of a defendant’s activities on the investor. Since, under that approach, an investor may be injured by a defendant’s negligent conduct as well as by his intentional conduct, section 10(b) should be read to proscribe both types of conduct.<sup>16</sup> However, the majority felt that such an interpretation of 10(b) was precluded by Congress’ choice of the language of section 10(b).

The Court’s opinion left three issues undecided. First, the Court did not reach the issue of whether civil liability could be imposed under section 10(b) for aiding and abetting, even with scienter, nor did it discuss the elements necessary to establish such a cause of action.<sup>17</sup> Second, the Court left open the question of whether “scienter” would be a necessary element in injunctive actions under section 10(b),<sup>18</sup> a requirement imposed in two recent district court cases where injunctive or other equitable relief was sought.<sup>19</sup> Finally, the Court left open the issue of whether some degree of reckless behavior would suffice as “scienter” under its holding.<sup>20</sup>

This last open question has already been involved in several cases,<sup>21</sup> including two in the Seventh Circuit. The first is *Sanders v. Nuveen & Co.*<sup>22</sup> The issue in *Sanders* was whether a securities dealer who relied on an issuer’s

14. 425 U.S. at 197.

15. *Id.* at 201-11.

16. The SEC went on to argue that “ordinary negligence,” such as appeared to exist in this case, was not enough to sustain the granting of money damages as distinct from injunctive relief which might be sought in an action brought by the SEC. Brief for SEC as Amicus Curiae at 23-36, *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976).

17. 425 U.S. at 191-92 n.7.

18. *Id.* at 193-94 n.12.

19. *SEC v. Bausch & Lomb, Inc.*, 420 F. Supp. 1226 (S.D.N.Y. 1976) (scienter must be pleaded and proved in a SEC action for injunctive relief); *Vacca v. Intra Management Corp.*, 415 F. Supp. 248 (E.D. Pa. 1976) (proof of scienter required in private action for equitable remedy of rescission).

20. 425 U.S. at 193-94 n.12.

21. *McLean v. Alexander*, 420 F. Supp. 1057 (D. Del. 1976) (accountant held liable under rule 10b-5 in absence of actual intent to defraud upon proof of actual knowledge of material facts not revealed and reckless misrepresentations); *Carroll v. Bear, Stearns & Co.*, 416 F. Supp. 998 (S.D.N.Y. 1976) (mere conclusory allegations of fraud insufficient where gist of plaintiff’s cause of action is negligent management of portfolio by broker); *Mallinckrodt Chem. Works v. Goldman, Sachs & Co.*, 420 F. Supp. 231 (S.D.N.Y. 1976) (no liability in absence of proof of scienter); *Raskas v. Supreme Equip. & Sys. Corp.*, [1976 Transfer Binder] *FED. SEC. L. REP.* (CCH) ¶95,694 (S.D.N.Y. 1976) (allegation that defendants “knew or should have known” about misrepresentations is sufficient to withstand motion to dismiss since knowledge is alleged).

22. 524 F.2d 1064 (7th Cir. 1975), *vacated*, 96 S. Ct. 1659 (1976).

certified financial statements in distributing the issuer's commercial paper could be held liable under section 10(b) and rule 10b-5 to purchasers of the paper when it was discovered that the financial statements were materially misleading in overstating the financial health of the issuer. The plaintiffs contended that Nuveen failed to conduct an adequate investigation which would have uncovered the fraudulent nature of the financial statements. There was no allegation that Nuveen had any knowledge of or otherwise participated in the fraud.

The Seventh Circuit, in an opinion by Judge (now Justice) Stevens, specifically avoided a discussion of the appropriate standard of culpability in a section 10(b) case and appeared to adopt the "flexible standard" used by the Seventh Circuit in its opinion in *Hochfelder*.<sup>23</sup>

Judge Stevens held that Nuveen's conduct did violate section 10(b) and rule 10b-5. The significant factor in the Court's opinion was Nuveen's status as an "underwriter." Even though the distribution was exempt from registration under the Securities Act of 1933<sup>24</sup> and Nuveen was not, therefore, subject to the provisions of section 11 of the 1933 Act,<sup>25</sup> the status of Nuveen as an "underwriter" had other consequences. First, as an underwriter, Nuveen had access to facts about the issuer not readily available to the public. Second, the relationship between an underwriter and its customer implies a recommendation of the security and a representation that the underwriter has made an investigation of the issuer which satisfies the standards of his profession.<sup>26</sup> The court felt that an underwriter could not ignore "the possibility of fraud", even in the case of an issuer with an impeccable reputation. Accordingly, Nuveen was under a "duty to make at least some investigation directed at the question of whether the ever present possibility of fraud is in fact a reality."<sup>27</sup> Having failed to make this investigation, Nuveen violated section 10(b) and rule 10b-5.

Nuveen filed its petition for certiorari on January 28, 1976. After its decision in *Hochfelder*, the Supreme Court vacated the decision in *Sanders* and remanded the case to the Seventh Circuit.<sup>28</sup> On remand, the Seventh

23. *Id.* at 1069. The court stated:

[W]e deliberately avoid any extended discussion of the broad question whether there is a generally applicable standard of culpability in Rule 10b-5 cases lying somewhere between the extremes of common law fraud on the one hand and mere negligence on the other. We assume the standard may be phrased differently in different circumstances. (footnotes omitted).

24. 15 U.S.C. § 77c(a)(3) (1970) [hereinafter referred to in the text as the 1933 Act].

25. 15 U.S.C. § 77k (1970). Although the trial of the case did not involve the registration issue, it has been raised by the Securities and Exchange Commission in an amicus brief filed with the Seventh Circuit on the remand of the case from the Supreme Court. Brief for SEC as Amicus Curiae at 48-51, *Sanders v. Nuveen & Co.*, Nos. 74-2047, 75-1260 (7th Cir. filed Oct. 21, 1976).

26. 524 F.2d at 1070.

27. *Id.* at 1071.

28. 96 S. Ct. 1659 (1976).

Circuit will undoubtedly consider the question left open by *Hochfelder*: Is there some degree of reckless behavior which will satisfy the “scienter” requirement? A glimpse into how the Seventh Circuit may approach this issue is afforded by another post-*Hochfelder* decision, *Bailey v. Meister Brau, Inc.*<sup>29</sup>

Plaintiff in *Bailey* was the president, treasurer and director of the James H. Black Company. James H. Black, Sr. owned 57,000 of the company’s 70,000 shares, a director’s wife owned 10,000 and plaintiff Bailey owned 3,000. By contract Bailey had a right of first refusal to purchase Mr. Black’s shares from him or, after his death, from his estate. Upon Mr. Black’s death, defendant Continental Illinois National Bank and Trust Company of Chicago became the owner of the shares as executor under Black’s will. Defendant Meister Brau, Inc. made an offer to the Continental to purchase Black’s shares. When advised of this, Bailey informed Continental he would exercise his right of first refusal within the sixty-day period provided in the contract. But, before that period expired, Continental accepted Meister Brau’s offer and sold the shares to Meister Brau, receiving as part of the consideration an indemnification agreement from Meister Brau. Meister Brau also purchased the 10,000 shares from the director’s wife. As part of the transaction all of the assets of James H. Black Company were transferred to a new company, Black Products Company of Delaware, Inc. and in return James H. Black Company received 70,000 shares of unregistered Meister Brau shares worth about half of the value of the assets transferred. Bailey was removed as president and treasurer, had his salary cut to the minimum allowed by his employment contract and was not reelected to the board. Bailey then brought a stockholder derivative suit as minority stockholder of James H. Black Company alleging that defendants Continental and Meister Brau, among others, violated section 10(b) and rule 10b-5. The complaint also alleged a section 10(b) claim on behalf of Bailey individually and a tort claim for intentional interference with Bailey’s contractual right of first refusal. The district court upheld Bailey’s claim on the tort count and the Seventh Circuit affirmed. The district court also held that defendant Continental violated section 10(b) and rule 10b-5 and awarded attorney’s fees based on that finding.<sup>30</sup>

Since the finding of liability under section 10(b) and rule 10b-5 was the legal predicate for the assessment of attorney’s fees, the Seventh Circuit had to review this holding before it could discuss the fee question. The gist of Bailey’s claims under section 10(b) and rule 10b-5 was that Continental, a controlling shareholder of James H. Black Company, committed a fraud upon the minority shareholder by allowing Meister Brau to receive all of the

29. 535 F.2d 982 (7th Cir. 1976).

30. *Id.* at 984 (citing district court opinions).

company's assets in exchange for unregistered Meister Brau stock worth much less than the assets transferred. There was no direct evidence that Continental knew that the unregistered Meister Brau stock was worth substantially less than the Black Company assets. The court quoted from the district court's findings that Continental was: "'grossly negligent in failing to recognize the unfairness of the asset transfer' and 'blinded by a conflict of interest, [Continental] wantonly ignore[d] evidence of the unfairness of [the] securities transaction. . . .'"<sup>31</sup>

On this record of "gross negligence" the Seventh Circuit affirmed the finding of violations of section 10(b) and rule 10b-5. In a footnote to its opinion the court stated that its holding is not contrary to the Supreme Court's opinion in *Hochfelder*.<sup>32</sup> It would have been more helpful if the Seventh Circuit had confronted the issue of what degree of reckless behavior would satisfy the Supreme Court's requirement of scienter in the body of its opinion rather than in a footnote. The casual treatment of this rather important issue by a visiting judge sitting by designation makes it difficult to gauge with certainty the Seventh Circuit's attitude on this issue. However, the affirmance of the finding of liability in *Bailey* indicates that the Seventh Circuit, in an appropriate case, will find that reckless conduct can lead to a violation of section 10(b) in the absence of knowledge or intent to defraud.

#### SECTION 14(a): MATERIALITY

*TSC Industries, Inc. v. Northway, Inc.*<sup>33</sup> also involved the reversal of a Seventh Circuit decision by the Supreme Court. In *Northway* the Court was faced with a conflict among the courts of appeals with regard to the definition of the term "materiality" as used in rule 14a-9<sup>34</sup> of the proxy rules. The genesis of the split of authority was an earlier Supreme Court case which also originated in the Seventh Circuit, *Mills v. Electric Auto Lite Co.*<sup>35</sup> In *Mills* the issue was the causal relationship between an allegedly false and misleading proxy statement and the approval of a merger which had to be shown in order to establish a violation of rule 14a-9.<sup>6</sup> Accepting the Seventh Circuit's finding that the omission was "material," the Court in *Mills* held:

31. *Id.* at 993 (citing *Sanders v. Nuveen & Co.*, 524 F.2d 1064, 1069 (7th Cir. 1975)).

32. 535 F.2d at 994 n.14.

33. 96 S. Ct. 2126 (1976), *rev'g* 512 F.2d 324 (7th Cir. 1975).

34. 17 C.F.R. § 240.14a-9 (1976). The rule, promulgated under section 14(a) of the 1934 Act, 15 U.S.C. § 78n(a) (1970), provides in pertinent part as follows:

(a) No solicitation subject to this regulation shall be made by means of any proxy statement, form of proxy, notice of meeting or other communication, written or oral, containing any statement which, at the time and in the light of the circumstances under which it is made, is false or misleading with respect to any material fact, or which omits to state any material fact necessary in order to make the statements therein not false or misleading or necessary to correct any statement in any earlier communication with respect to the solicitation of a proxy for the same meeting or subject matter which has become false or misleading.

35. 396 U.S. 375 (1970).

36. *Id.* at 377.

Where there has been a finding of materiality, a shareholder has made a sufficient showing of causal relationship between the violation and the injury for which he seeks redress if, as here, he proves that the proxy solicitation itself, rather than the particular defect in the solicitation materials, was an essential link in the accomplishment of the transaction.<sup>37</sup>

In reaching this conclusion Justice Harlan commented upon the Seventh Circuit's finding that the omission was "material" as follows:

Where the misstatement or omission in a proxy statement has been shown to be "material," as it was found to be here, that determination itself indubitably embodies a conclusion that the defect was of such a character that it might have been considered important by a reasonable shareholder who was in the process of deciding how to vote. This requirement that the defect have a significant *propensity* to affect the voting process is found in the express terms of Rule 14a-9, and it adequately serves the purpose of ensuring that a cause of action cannot be established by proof of a defect so trivial, or so unrelated to the transaction for which approval is sought, that correction of the defect or imposition of liability would not further the interests protected by § 14(a).<sup>38</sup>

Thus, in *Mills*, the Court decided that a more liberal view of the element of causation was justified in cases where the untrue or omitted fact was found to be "material."<sup>39</sup> However, by accepting the Seventh Circuit's determination that the particular omission involved in *Mills* was material, the Court was not called upon to delineate the proper standard of materiality.

This question was presented in three post-*Mills* decisions in the courts of appeals. In *Gerstle v. Gamble-Skogmo, Inc.*,<sup>40</sup> Judge Friendly of the Second Circuit considered Justice Harlan's comments in *Mills* in light of the purposes of section 14(a) of the 1934 Act and the rules promulgated thereunder. He concluded that the proper definition of materiality was contained in the second sentence of Harlan's comments that the defect in the proxy materials must have a "significant *propensity*" to affect the voting process.<sup>41</sup> The next year the Fifth Circuit adopted the same test of materiality in *Smallwood v. Pearl Brewing Co.*<sup>42</sup>

One year later the Seventh Circuit had the opportunity to define the standard of materiality in a proxy solicitation case. Focusing on the same two

37. *Id.* at 385.

38. *Id.* at 384 (footnote omitted).

39. The Supreme Court took a similar position in cases under section 10(b) of the 1934 Act, 15 U.S.C. § 78j(b) (1970), and rule 10b-5, 17 C.F.R. § 240.10b-5 (1976), in *Affiliated Ute Citizens v. United States*, 406 U.S. 127 (1972), it held that proof of reliance would not be required in cases where an omitted fact was found to be material. The issue of the definition of the concept of "materiality" was not presented in *Affiliated Ute*. See *TSC Indus., Inc. v. Northway*, 96 S. Ct. 2126, 2132 n.9 (1976).

40. 478 F.2d 1281 (2d Cir. 1973).

41. 478 F.2d at 1302.

42. 489 F.2d 579, 603-04 (5th Cir.), *cert. denied*, 419 U.S. 873 (1974).



sentences in *Mills* as had the Second and Fifth Circuits, the Seventh Circuit selected a more expansive approach to materiality. Judge Swygert, writing for the court in *Northway, Inc. v. TSC Industries, Inc.*,<sup>43</sup> described the two tests which he found suggested by Justice Harlan:

[T]he "might have" test would ask whether a reasonable mind could conclude that the omitted fact is so irrelevant that it would never reasonably be considered important. The "significant propensity" test would ask whether a reasonable mind could conclude that the fact is less than significant in its potential to affect the voting process. Many facts which are relevant within the first test could reasonably be said to have less than a significant propensity to affect the voting process taken as a whole, even though for some few stockholders these same facts could be determinative.<sup>44</sup>

The Seventh Circuit selected the "might have" test as the one which better served the policies underlying section 14(a). The court feared that the more restrictive "significant propensity" test would undercut the prophylactic effect of the proxy disclosure provisions. Responding to Judge Friendly's fear that the "might have" test was too low a threshold for materiality, Judge Swygert responded that the element of the "reasonable mind" would protect corporations from liability for minor omissions. The court proceeded to use the "might have" test to analyze the alleged omissions. It concluded that four of the five omissions were of material facts and that as to those plaintiff was entitled to summary judgment.

The Supreme Court, without dissent, reversed.<sup>45</sup> The Court agreed with the Seventh Circuit as to the broad remedial purposes of section 14(a) and the desire to supply shareholders with information and explanation as to the matters upon which they are asked to vote. But, echoing a sentiment recently found in *Blue Chip Stamps v. Manor Drug Stores*,<sup>46</sup> the Court stressed that there are limits to the disclosure policy. The Court feared that corporations, faced with a "might have" test, would "bury the shareholder in an avalanche of trivial information"<sup>47</sup> to avoid potential liability, thereby confusing shareholders rather than assisting them. To avoid this danger, the Court held that the better standard of materiality would be:

[A]n omitted fact is material if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote . . . . [This standard] does not require proof of a substantial likelihood that disclosure of the omitted fact would have caused the reasonable investor to change his vote. What the standard does contemplate is a showing of a substantial likelihood that, under all the circumstances, the omitted fact would have assumed

43. 512 F.2d 324 (7th Cir. 1975), *rev'd*, 96 S. Ct. 2126 (1976).

44. *Id.* at 330.

45. The decision was 8-0. Justice Stevens did not participate in the decision.

46. 421 U.S. 723, 739-44 (1975).

47. 96 S. Ct. at 2132-33.

actual significance in the deliberations of the reasonable shareholder. Put another way, there must be a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the "total mix" of information made available.<sup>48</sup>

The difference between the definitions of "materiality" adopted by the Supreme Court and the Seventh Circuit is more than just "gossamer" as was suggested by Judge Friendly in *Gerstle*.<sup>49</sup> The Supreme Court found that each of the four omissions which was material as a matter of law under the Seventh Circuit's test, was not material as a matter of law under its test. The definition adopted by the Supreme Court appears to strike a better balance between investor protection and disclosure and the burdens placed on corporations in complying with disclosure provisions. If corporations had to include in disclosure documents all information which "might" influence an investor, even if only a reasonable investor, the documents would become more unmanageable and complex than they already are and neither investors nor corporations would benefit. Also, since liability under several anti-fraud provisions of the securities acts also involves consideration of the materiality of the misrepresented or omitted fact,<sup>50</sup> the Supreme Court decision in *Northway* is consistent with the recent trend of the Court to more narrowly construe these provisions.<sup>51</sup>

#### SECTION 16(b): LIABILITY AND MEASURE OF DAMAGES

In *Allis-Chalmers Manufacturing Co. v. Gulf & Western Industries, Inc.*<sup>52</sup> the Seventh Circuit was confronted with three interesting issues under section 16(b) of the 1934 Act,<sup>53</sup> two concerning liability and one concerning

48. *Id.* at 2133.

49. 478 F.2d at 1302.

50. *See, e.g.*, sections 10(b) and 14(e) of the 1934 Act, 15 U.S.C. §§ 78j(b), 78m(e) (1970).

51. *See, e.g.*, *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723 (1975) (private action under section 10(b) and rule 10b-5 confined to actual purchasers or sellers of securities), and *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976) (see discussion in text following note 15, *supra*).

52. 527 F.2d 335 (7th Cir. 1975), *cert. denied* as to liability, 423 U.S. 1078 (1976), *cert. denied* as to damages, 424 U.S. 928 (1976).

53. Section 16(b), 15 U.S.C. § 78p(b) (1970), provides in pertinent part:

(b) For the purpose of preventing the unfair use of information which may have been obtained by such beneficial owner, director, or officer by reason of his relationship to the issuer, any profit realized by him from any purchase and sale, or any sale and purchase, of any equity security of such issuer (other than an exempted security) within any period of less than six months . . . shall inure to and be recoverable by the issuer, irrespective of any intention on the part of such beneficial owner, director, or officer in entering into such transaction of holding the security purchased or of not repurchasing the security sold for a period exceeding six months. . . .

This subsection shall not be construed to cover any transaction where such beneficial owner was not such both at the time of the purchase and sale, or the sale and purchase, of the security involved, or any transaction or transactions which the Commission by rules and regulations may exempt as not comprehended within the purpose of this subsection.

As used in section 16(b), the term "beneficial owner" means any person who owns 10% or more of any class of equity securities issued by a corporation. 15 U.S.C. § 78p(a) (1970).

the measure of damages. The facts of the case were relatively simple. In July, 1968 Gulf & Western acquired, through a public tender offer, 3,000,000 shares of common stock of Allis-Chalmers, representing more than 10% of the outstanding shares of the class. In August, Gulf & Western acquired an additional 248,000 Allis-Chalmers shares from Oppenheimer Fund, Inc., a mutual fund. In October, Gulf & Western reached an agreement to sell its 3,248,000 Allis-Chalmers shares to White Consolidated Industries and in December the transaction was closed. In January, 1969 Allis-Chalmers filed suit under section 16(b) to recover the profits received by Gulf & Western on the sale to White.

After trial the district court found Gulf & Western liable under section 16(b) for all profits realized on the sale of the 3,248,000 shares.<sup>54</sup> In reaching this conclusion the district court interpreted the requirement of section 16(b) that a beneficial owner be such "at the time of the purchase" to mean "simultaneous with the purchase."<sup>55</sup> Thus, Gulf & Western's initial purchase of more than 10% of the Allis-Chalmers shares exposed it to automatic liability upon a sale of such shares at a profit within six months. The district court's interpretation of section 16(b) was consistent with opinions in the Second Circuit.<sup>56</sup>

The Seventh Circuit, in an opinion by Judge Swygert, reversed in part and found Gulf & Western liable only for the profits realized on the purchase and sale of 248,000 shares, not for the 3,000,000 shares, on the ground that Gulf & Western was not a 10% owner at the time of its purchase of the 3,000,000 shares. The court also reversed as to the measure of damages.

Judge Swygert began his analysis with the first sentence of section 16(b). That sentence clearly states that section 16(b) seeks to prevent officers, directors or 10% owners from profiting by the use of information which they received as a result of their status as officers, directors or 10% owners. So, Judge Swygert reasoned, if one does not have the requisite relationship prior to the initial transaction in a purchase/sale or sale/purchase sequence, then such person could not have been motivated by information received "by reason of his relationship [*i. e.*, officer, director or 10% owner] to the issuer." Accordingly, the court held that Gulf & Western did not violate section 16(b) with regard to its purchase and sale of 3,000,000 Allis-Chalmers shares within a six-month period because Gulf & Western was not an insider prior to its purchase of the 3,000,000 shares.

Having reached this conclusion, it was not necessary for Judge Swygert

54. 372 F. Supp. 570 (N.D. Ill. 1974).

55. 372 F. Supp. at 576.

56. *Newmark v. RKO General, Inc.*, 425 F.2d 348 (2d Cir.), *cert. denied*, 400 U.S. 854 (1970); *Stella v. Graham-Paige Motors Corp.*, 104 F. Supp. 957, 960 (S.D.N.Y. 1952), *aff'd in part, remanded in part*, 232 F.2d 299 (2d Cir.), *cert. denied*, 352 U.S. 831 (1956).

to interpret the second sentence of section 16(b), the exemptive provision, which requires a 10% owner to be such "both at the time of the purchase and sale, or the sale and purchase." If Gulf & Western was not a 10% beneficial owner at the time of the 3,000,000 share purchase and therefore not liable, it is irrelevant to consider whether Gulf & Western had to be a beneficial owner at the time of sale. Nonetheless, Judge Swygert analyzed the exemptive provision and found that as to each sequence, purchase/sale or sale/purchase, a beneficial owner must be such only at the time of the initial portion of the sequence. Under this interpretation of the exemptive provision of a 10% owner's status at the time of the closing portion of a purchase/sale or sale/purchase sequence is irrelevant.

Allis-Chalmers filed its petition for certiorari in the Supreme Court on October 16, 1975. On January 13, 1976 the Supreme Court issued its opinion in *Foremost-McKesson, Inc. v. Provident Securities Co.*<sup>57</sup> In that case Provident Securities had sold two-thirds of its assets to Foremost-McKesson in exchange for convertible debentures of Foremost-McKesson which were immediately convertible into more than 10% of Foremost-McKesson's stock. Within six months Provident sold a portion of the debentures to a group of underwriters. Provident then sought a declaratory judgment that its purchase and sale did not subject it to liability under section 16(b).

The Supreme Court held, as did the Seventh Circuit, that in a purchase/sale transaction a 10% owner had to be such prior to the purchase under scrutiny. However, the Supreme Court's analysis was different from Judge Swygert's. The Supreme Court concentrated on the exemptive provision which required a 10% owner to be such "both at the time of the purchase and sale, or the sale and purchase." Reviewing the legislative history, the Court found that the purpose of the exemptive provision was to preserve, for 10% owners, the requirement that they be such prior to the purchase under scrutiny. Unlike the Seventh Circuit, the Court did not go further in its analysis, expressly refusing to comment on the Seventh Circuit's conclusions that (1) all insiders, directors and officers as well as beneficial owners, had to acquire their insider status before the initial transaction in a subject sequence,<sup>58</sup> and (2) insider status at the time of the closing transaction in a sequence was irrelevant.<sup>59</sup> However, since the result in *Allis-Chalmers* would be the same under the Supreme Court's analysis, certiorari was denied.<sup>60</sup>

It is submitted that Judge Swygert's scholarly but gratuitous analysis of the exemptive provision would not have been accepted by the Supreme Court.

57. 423 U.S. 232 (1976).

58. *Id.* at 243 n.16.

59. *Id.* at 250 n.25.

60. 423 U.S. 1078 (1976).

In an earlier opinion in *Reliance Electric Co. v. Emerson Electric Co.*<sup>61</sup> the Supreme Court considered the case of a corporation which acquired 13.2% of the stock of another corporation and then made two sales within six months, one of 3.24% and one of the remaining 9.96%. The Court held that the exemptive provision of 16(b) precluded liability as to the second sale because the seller was not a 10% owner "at the time of . . . the sale." Although the Court in *Foremost-McKesson* acknowledged that under its holding in that case there would have been no liability for either sale in *Emerson Electric*,<sup>62</sup> the Court did not repudiate its holding in that case. Juxtaposition of the Court's opinions in *Emerson Electric* and *Foremost-McKesson* results in an interpretation of the exemptive provision which is inconsistent with Judge Swygert's. In other words, the Supreme Court would seem to require a 10% holder to be such prior to the opening and closing portions of a sequence, whereas Judge Swygert would only require 10% ownership prior to the opening transaction. As Judge Swygert noted, in every purchase/sale sequence, the requirement that a 10% owner be such prior to the time of the purchase will always result in such person owning 10% prior to the time of the subject sale.<sup>63</sup> Thus, in a purchase/sale sequence, the Court's opinions in *Emerson Electric* and *Foremost-McKesson* are compatible with Judge Swygert's opinion in *Allis-Chalmers*. The inconsistency would arise only in a case of a sale/purchase sequence where the person owns less than 10% before the purchase. Further, under Judge Swygert's analysis, all insiders, not just 10% holders, must have such status prior to the initial transaction in a subject sequence, and status at the time of the closing transaction would be irrelevant. This analysis renders the exemptive provision of section 16(b) which applies only to 10% beneficial owners wholly superfluous.

A final consideration in predicting the Supreme Court's approach is that Justice Stevens, when a member of the Seventh Circuit, was polled on whether a rehearing en banc should have been granted in *Allis-Chalmers*. He expressed his opinion that Judge Swygert's analysis is incorrect under both the Supreme Court's decision in *Emerson Electric* and the language of the exemptive provision.<sup>64</sup> The combination of these factors indicates that the Supreme Court would not have accepted the analysis of the Seventh Circuit in its entirety.

The second liability issue in *Allis-Chalmers* involved Gulf & Western's second purchase of 248,000 Allis-Chalmers shares from a mutual fund. As Gulf & Western already owned 3,000,000 shares at the time of the purchase,

61. 404 U.S. 418 (1972).

62. 423 U.S. at 250 n.25.

63. 527 F.2d at 348 n.12.

64. *Id.* at 341 n.5.

it qualified as a 10% owner prior to the opening transaction in a purchase/sale sequence. Thus, under the court's analysis, automatic liability would attach under section 16(b) upon the profitable sale to White which took place within six months.

Gulf & Western attempted to avoid automatic liability on the purchase/sale of the 248,000 shares by invoking the Supreme Court decision in *Kern County Land Co. v. Occidental Petroleum Corp.*<sup>65</sup> In *Kern* the Supreme Court did not assess automatic liability as required under section 16(b). Instead, the Court analyzed the transaction and concluded that there was no possibility of short term speculative abuse of the type which 16(b) was designed to prevent.

Gulf & Western argued that under the rule of *Kern* the court should examine the transaction to see if there was the possibility of short term use of inside information. The Seventh Circuit rejected this contention and held that Gulf & Western was liable under section 16(b) for the profits from the purchase and sale of the 248,000 shares. First, the court held that *Kern* did not apply to the case before it. Under *Kern* before the question of the possibility of the use of inside information becomes relevant, there must be present an "unorthodox" purchase or sale, or, phrased otherwise, the threshold question is whether one or the other transaction should be regarded as a purchase or sale for purposes of section 16(b). In *Kern* the 10% shareholder gave up its holdings of the target company as a result of a defensive merger of the target with a third corporation. This "sale" of the target's shares was found not to be a voluntary act attributable to the party sought to be charged with violating 16(b). In contrast, the Seventh Circuit found that neither Gulf & Western's purchase, nor its sale of the 248,000 Allis-Chalmers shares, was "unorthodox." Both were voluntary acts by Gulf & Western.

Even if it deemed either the purchase or the sale unorthodox, the court found that it could not conclude that no opportunity for short term speculative abuse existed. The court noted that after it acquired its 3,248,000 shares of Allis-Chalmers, Gulf & Western received information from Allis-Chalmers' chairman that the future prospects of the company were not very bright. Subsequently, Gulf & Western arranged its sale to White. The court found that the "possibility" existed that Gulf & Western actually did use inside information as the basis of its decision to sell the Allis-Chalmers shares. Based on this analysis, the court held that Gulf & Western was liable under section 16(b) for the profit it made on its sale of 248,000 shares to White.

The final issue before the court was the calculation of Gulf & Western's "profit." The most interesting aspect of the court's analysis of the appropriate measure of damages was its discussion of the six month, 8-1/2%

65. 411 U.S. 582 (1973).

unsecured promissory note for \$93,680,000 which Gulf & Western received from White as partial consideration for the 3,248,000 Allis-Chalmers shares. The district court discounted the note by 5% to account for the risk factors involved in a note of that magnitude and to produce a value reflecting what a disinterested third party would pay for the note. The district court rejected evidence that the note was paid in full at maturity.

This, the Seventh Circuit found, was error. It held that "evidence of payment in full, if available at the time of trial, should control the determination of 'profit realized.'" <sup>66</sup> Since the note was paid in full by White, the full value of the note should have been included in the calculation of the consideration received by Gulf & Western. The court had no hesitation in reaching this result "given the broad remedial purpose of section 16(b), its limited impact, and the intent of Congress . . . to 'eradicate speculative abuses by removing difficulties in proof.'" <sup>67</sup>

The court's holding in *Allis-Chalmers* that a subsequent event, payment in full, should control the valuation of consideration for purposes of section 16(b) is not troublesome in the context of that case, *i.e.*, a short term note which could be considered the equivalent of cash. However, problems would arise if the holding were expanded to cases involving longer term debt securities and events other than payment in full. For example, what if Gulf & Western had received long term marketable debt securities worth \$93 million at the closing but worth \$123 million or \$53 million at the time of trial? Does the court advocate a reference to values at the time of trial in every case? A shift of the valuation date of the consideration to the date of trial in every case would create a situation where the "profits" realized in a 16(b) transaction could be affected by factors having nothing to do with the policies behind section 16(b).

#### STATUTE OF LIMITATIONS

In *Parrent v. Midwest Rug Mills, Inc.*<sup>68</sup> the Seventh Circuit established that the three-year statute of limitations found in the Illinois Blue Sky statute<sup>69</sup> was applicable to suits brought under those anti-fraud provisions of the federal securities acts where no statute of limitations is prescribed.<sup>70</sup> In two

66. 527 F.2d at 357.

67. *Id.* Although Gulf & Western was able to limit its liability to the 248,000 share transaction as opposed to the total 3,248,000 shares involved, the court's ruling on the measure of damages more than offset Gulf & Western's victory. The trial court's ruling granted Allis-Chalmers damages in the amount of \$1,135,838.00 on the 3,248,000 share transaction whereas the Seventh Circuit's ruling resulted in a damage awarded of \$2,465,680.47 on the 248,000 share transaction. Gulf & Western's petition for certiorari on the issue of the measure of damages was denied. 424 U.S. 928 (1976).

68. 455 F.2d 123 (7th Cir. 1972).

69. ILL. REV. STAT. ch. 121 1/2, § 137.13D (1975).

70. *Parrent* relied in part on the Eighth Circuit's decision in *Vanderboom v. Sexton*, 422

cases decided within five days last term, the Seventh Circuit considered the applicability of the equitable tolling doctrine to the three-year statute of limitations.

The first case to be decided was *Goldstant v. Bear, Stearns & Co.*<sup>71</sup> Plaintiffs in *Goldstandt* were partners in a broker-dealer firm which was registered under the 1934 Act and a member of the National Association of Securities Dealers<sup>72</sup> but was not a member of a national securities exchange. Defendant Bear, Stearns is a well-known securities firm and is a member of the New York Stock Exchange. For years plaintiffs' brokerage house provided services for Bear, Stearns on the floor of the Chicago Mercantile Exchange. In late 1967 defendant Turkish, a limited partner in Bear, Stearns, suggested to plaintiffs that they could earn profits by becoming a customer of Bear, Stearns and selling short certain securities which were the subject of pending registration statements. On "several occasions" plaintiffs questioned the legality of such transactions but each time were told by Turkish that he "had checked with the legal department of Bear, Stearns and that the practice was 'proper.'" <sup>73</sup> From 1968 through 1970 plaintiffs engaged in thirty trades employing the practice suggested by Turkish.

In June, 1971, plaintiffs were served with a complaint by the NASD alleging, *inter alia*, that the short sales were violations of the NASD Rules of Fair Practice.<sup>74</sup> *Goldstandt* called Turkish who informed him that the practice was illegal and that Turkish knew it was illegal all the time. Some time more than three years after the last short sale, plaintiffs filed suit alleging that Bear, Stearns and Turkish violated section 10(b) and rule 10b-5, section 17 of the 1933 Act, rule 405 of the rules of the New York Stock Exchange, section 1 of article III of the NASD rules and that their acts constituted common law fraud. The district court found that the suit was not filed within three years of the date of the last sale involved and dismissed the federal law claims. The pendent common law claim was then also dismissed.

The Seventh Circuit affirmed. Judge Swygert noted that two types of

F.2d 1233 (8th Cir.), *cert. denied*, 400 U.S. 852 (1970), which relied on the holding in *Myzel v. Fields*, 386 F.2d 718 (8th Cir. 1967), *cert. denied*, 396 U.S. 951 (1968), that section 10(b) of the 1934 Act encompassed negligent as well as intentional misconduct. Query whether the statute of limitations question is ripe for reexamination after the Supreme Court's opinion in *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976). *Cf.* *Bailey v. Piper, Jaffray & Hopwood, Inc.*, 414 F. Supp. 475 (D. Minn. 1976) (the court held that an earlier Minnesota case adopting a six year common fraud statute of limitation could not stand after *Ernst & Ernst* and that the three year limitation period of the Minnesota Blue Sky law was more appropriate).

71. 522 F.2d 1265 (7th Cir. 1975).

72. Hereinafter referred to in the text as NASD.

73. 522 F.2d at 1266.

74. As to the status of such sales under the federal securities laws, see SEC Release Nos. 33-5323 & 34-9824, 1 FED. SEC. L. REP. (CCH) ¶ 4816 (1972), 17 C.F.R. § 231.5323 (1976); Proposed Rule 10b-21, 2 FED. SEC. L. REP. (CCH) ¶ 22,741 issued in SEC Release No. 34-11328, [1974-1975 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 80,147 (1975).



fraudulent behavior could toll the running of the three-year statute: fraud undiscovered by plaintiff's due diligence and fraud concealed by defendant's conduct. Since plaintiffs did not allege concealment, Judge Swygert focused only on plaintiffs' due diligence. Judge Swygert held that plaintiffs were not diligent in that they did not obtain independent legal advice concerning the short sale trades. Plaintiffs argued that until the NASD complaint was filed, they had no reason to disbelieve Turkish or to obtain an independent legal opinion. But, the court felt that given the general sophistication of the plaintiffs and the ease with which they could have obtained a second opinion, the policies of the statute of limitations would be better served by holding that plaintiffs were obligated to "bestir themselves to inquire."<sup>75</sup>

In the second case, *Sperry v. Baggren*,<sup>76</sup> the court was faced with enforcing the statute of limitations against an unsophisticated investor and the result was different. Plaintiff was the administrator of the estate of Mr. Munn, a retired employee of Badger Manufacturing Company of Marinette, Wisconsin. Mr. Munn resided in Florida. Defendants were a 70% shareholder of Badger and his son, a vice-president of Badger. The son visited Mr. Munn in Florida and contracted with him to purchase Mr. Munn's 226 Badger shares at \$200 per share over a five-year period. A little more than two months later the defendants agreed to sell their Badger shares to another corporation interested in acquiring Badger for \$781 per share. The son assigned his contract with Munn to the acquiring corporation and subsequently persuaded Munn to sell all his shares in one transaction for a lump sum of \$200 per share discounted to present value. The son never informed Munn of the \$781 per share price paid by the acquiring corporation. A complaint alleging violations of section 10(b) and rule 10b-5 was filed in the Eastern District of Wisconsin more than three years after the sale by Munn.<sup>77</sup> The district court held that Munn could have discovered the fraud before the three-year period expired and granted summary judgment for defendants.

This time the Seventh Circuit reversed. Judge Tone held that the presence or absence of concealment of the fraud was an issue of fact which should be decided only by the trier of fact. Even if no active concealment were found, it was an issue of fact whether the plaintiffs could have discovered the fraud with the exercise of due care. In this regard the court noted that the existence of a fiduciary relationship between the parties would lessen the plaintiff's duty of inquiry. Furthermore, the mere fact that announcement of the acquisition appeared in two Wisconsin papers and in Moody's Industrials

75. 522 F.2d at 1269.

76. 523 F.2d 708 (7th Cir. 1975).

77. In *Kramer v. Loewi & Co., Inc.*, 357 F. Supp. 83 (E.D. Wis. 1973), it was held that the three-year limitation period of Wisconsin's Blue Sky law applied to actions under section 10(b) which arose before January 1, 1970. After that date the statute of limitations is one year.

would not, as a matter of law, be considered sufficient to notify a Florida resident, especially in view of the fact that none of the announcements contained the \$781 per share price.

The different attitude of the Seventh Circuit toward application of the equitable tolling doctrine in these two cases seems clearly justified. In *Goldstandt*, the plaintiffs were brokers and should have realized that their short sales might depress the offering price of the securities under registration, thereby insuring that they could cover their short sales with lower priced stock. This factor should have caused them to be somewhat skeptical of Turkish's representations. Apparently, the court felt that plaintiffs' anticipation of profits affected their willingness to rely on Turkish's statements. In contrast, plaintiff in *Sperry* appeared to be a passive victim of a plan to deprive him of profits. The Seventh Circuit's application of the equitable tolling doctrine in these two cases seems most equitable.

#### DEFINITION OF "SECURITY" AND "SALE"

Although the scope of this article does not include decisions by the district courts, a recent case decided by Judge Kirkland of the Northern District of Illinois has caused some alarm among persons involved in the employee benefits field. In *Daniel v. International Brotherhood of Teamsters*<sup>78</sup> Judge Kirkland held that an employee's participation in an involuntary, noncontributory pension plan represented the sale of a security so that allegations of misleading statements and omissions of material facts regarding provisions of the plan were sufficient to state a cause of action under section 10(b), rule 10b-5 and section 17(a) of the 1933 Act.<sup>79</sup> Judge Kirkland found that participation in a pension plan was an "investment contract" and hence a "security" as defined in sections 2(1) of the 1933 Act<sup>80</sup> and 3(a)(10) of the 1934 Act.<sup>81</sup> Furthermore, participation in a pension plan satisfied all the elements of a "security" required by the Supreme Court test in *SEC v. W.J. Howey Co.*<sup>82</sup> since a pension plan represented a common enterprise involving an element of risk, entered into with the expectation of profit and where the sole power of control is vested in the trustees.

The court further held that a "sale" of such security occurred by the employee's giving of services, or alternatively by the contribution of a portion

78. 410 F. Supp. 541 (N.D. Ill. 1976).

79. 15 U.S.C. § 17q(a) (1970).

80. 15 U.S.C. § 77(b)(1) (1970) provides in part as follows: "(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 . . . ."

81. 15 U.S.C. § 78c(a) (10) (1970) provides in part as follows: "(10) The term 'security' means any note, stock, treasury stock, bond, debenture, certificate of interest or participation in any profit-sharing agreement . . . ."

82. 328 U.S. 293 (1946).

of his wages, in exchange for the participation. This latter holding directly contradicts a long-established position of the Securities and Exchange Commission that participation in mandatory, noncontributory pension plans does not involve the "sale" of a security.<sup>83</sup>

Judge Kirkland's interpretation could have far-reaching effects under the securities laws. Involuntary, noncontributory pension plans would have to be registered under the 1933 Act and prospectuses given to all job applicants who could become eligible to participate before they are hired. Additionally, it would seem that prospectuses should be distributed to union members before voting on collective bargaining agreements. Further, many disputes relating to interpretation and application of the terms of a plan could be transformed into fraud suits under the anti-fraud provisions of the 1933 and 1934 Acts. The court did not mention these factors in its opinion and it is not known whether all the ramifications of the court's holding were considered by the court in reaching its conclusion.<sup>84</sup>

#### CONCLUSION

Seventh Circuit decisions in securities cases during the past two terms, especially those written by Judge Swygert, have tended to construe provisions of the securities acts in a broad manner to protect the investing public. This approach is evidenced by the court's opinions in *Hochfelder*, *TSC Industries*, *Allis-Chalmers* and *Bailey*. The court's expansive approach has collided with the strict construction adopted by the Supreme Court in securities cases. The result has been reversals of the Seventh Circuit in *Hochfelder* and *TSC Industries*. In those cases the Seventh Circuit would have created easier standards for recovery in securities cases than the Supreme Court. Within the parameters established by the Supreme Court, the Seventh Circuit seems determined to continue to interpret the securities in a broad manner to fully protect investors. The opinion in *Bailey* may be indicative in this regard.

The high quality legal analysis and writing which characterized all of the Seventh Circuit decisions in this area was much appreciated by the authors. Practitioners in this circuit can expect to find a highly qualified panel to hear appeals in securities cases.

83. Opinions of Assistant General Counsel of Commission, [1941-1944 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 75,195; Senco Prods., Inc., [1976-1977 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 80,775 (1976).

84. *Daniel* has been appealed to the Seventh Circuit, *Daniel v. International Bhd. of Teamsters*, appeal docketed, No. 76-1855 (7th Cir. Sept. 1, 1976). The SEC has filed an amicus brief with the Seventh Circuit supporting Judge Kirkland as to 10b-5 but not as to registration requirements under the 1933 Act.