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THE PURPOSE OF this article is to summarize the pronouncements of the United States Court of Appeals for the Seventh Circuit in the area of securities law during the past year. The cases hereinafter discussed will deal with the definition of a security, what is a public offering of securities, the applicable statutes of limitations with respect to securities law fraud actions, substantive conduct amounting to securities law fraud and certain issues of damages and liability for violation of reporting requirements.

In recent years securities law practice has burgeoned into a vast and complicated area of the law, spawning specialists who, notwithstanding their immersion into the intricacies of federal and state securities laws, find it difficult to keep abreast of all the judicial decisions, administrative interpretations and other requirements of a multitude of regulatory agencies which directly affect practice in the field. Treatises,[1] looseleaf services,[2] and periodicals[3] now abound. An adequate discussion of developments in securities law requires more than a summary article concerning selected decisions of one federal circuit. Nevertheless, it is hoped that such a summary article will serve a useful purpose in aiding the reader to review a manageable section of developments in the field.

DEFINITION OF SECURITY

Since *SEC v. W.J. Howey Co.*,[4] focus on whether a particular transaction or set of financial facts fits the definition of security in the statutory context has become important in securities litigation. During this past year, a district court in the Seventh Circuit addressed itself to this issue, relying in part on prior pronouncements of the court of

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1. *See generally* LOSS, SECURITIES REGULATION (2d ed. 1961).
2. *E.g.*, CCH weekly publication FEDERAL SECURITIES LAW REPORTER.
3. *E.g.*, BNA weekly publication SECURITIES REGULATION AND LAW REPORT.
4. 328 U.S. 293 (1946).

appeals.[5] In *Stevens v. Woodstock, Inc.*,[6] the plaintiffs claimed that they were induced to deposit large sums of money with the defendants who were brokers in commodities futures. Ness, an individual defendant, allegedly represented that profits would result from the defendant's efforts in trading commodities futures. The corporate defendants allegedly conspired with Ness to make unauthorized transactions on commodities futures markets from the commingled funds of the plaintiffs such that at any given time it would be impossible to determine which individual's money was being used to consummate a given transaction. As a result of this conduct, Stevens claimed a loss of the entire amount he deposited, which was in excess of $150,000. The plaintiffs argued that their commingled brokerage accounts constituted investment contracts and were therefore securities subject to the protection of the federal securities laws.[7] In holding the commingled accounts to be without the statutory definition, Judge Tone, reiterated the *Howey* holding that "the test is whether the scheme involves an investment of money in a common enterprise with profits to come solely from the efforts of others."[8] Citing *Milnarik v. M-S Commodities*,[9] the district court held that because the requirement of a common enterprise is lacking, a discretionary trading account in com-

5. *See generally* Horwich & Ruder, *Securities Law*, 50 CHI. KENT L. REV. 362, 364 (1973) [hereinafter cited as Horwich & Ruder].

6. 372 F. Supp. 654 (N.D. Ill. 1974).

7. The Securities Act of 1933, 15 U.S.C. § 77a et seq. (1971) (hereinafter referred to as the 1933 Act), and the Securities Exchange Act of 1934, 15 U.S.C. § 78a et seq. (1971) (hereinafter referred to as the 1934 Act), contain substantially similar definitions of "security." Section 2(1) of the 1933 Act states:

> 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, investmeent contract, voting trust certificate, certificate of deposit for a security, fractional and 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.

Section 3(a)(10) of the 1934 Act states:

> The term 'security' means any note, stock, treasury stock, bond, debenture, certificate of interest or participation in any profit sharing agreement or in any oil, gas or other mineral royalty or lease, any collateral trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting trust certificate, certificate of deposit, for a security, or in general, any instrument commonly known as a 'security'; or any certificate of interest or participation in, temporary or interim certificate for, receipt for, or warrant or right to subscribe to or purchase, any of the foregoing; but shall not include currency or any note, draft, bill of exchange or bankers' acceptance which has a maturity at the time of issuance of not exceeding nine months, exclusive of days of grace, or any renewal thereof, the maturity of which is likewise limited.

Section 3(a)(11) of the 1934 Act defines the term "equity security" for purposes of the 1934 Act to include what are commonly known as convertible equity securities.

8. 328 U.S. at 301.

9. 457 F.2d 274 (7th Cir. 1972).

modities futures is not a security. The court reasoned that there was no common enterprise in *Stevens* since the plaintiffs by their own admission stated that the accounts were commingled on an unauthorized basis. Without a common purpose, there could be no common enterprise and hence, no security.

Whether the result in *Stevens* is correct is open to some question. Certainly the decision is based upon a literal reading of statutory definitions. Different results have been reached by other courts using similar analyses.[10] Unfortunately, this lack of predictability on the threshold issue of what is a security is bound to continue, and the pervasion of the securities laws into various areas of commerce will mean more difficult questions to be considered by the securities bar.

WHAT IS A PUBLIC OFFERING

Nowhere in the federal securities laws can one find a definition of what specifically is to be deemed a "public offering". This causes concern to securities lawyers since offerings of securities in interstate commerce must be registered under the 1933 Act[11] unless they are exempt from registration as transactions by an issuer not involving any "public offering",[12] or are securities or transactions exempt under other provisions of statute.

In *SEC v. Dolnick*,[13] an enforcement action was brought against an individual who allegedly participated in the distribution of unregistered Pig'n Whistle securities from November 1968 to June 1970 by mailing the common stock and convertible debentures and by selling such securities through prospectuses. According to the findings in the district court, the defendant Dolnick knew that Pig'n Whistle shares he pledged to banks from May 1969 to January 1970 were neither registered nor exempt from registration. Dolnick sold some of the pledged shares of Pig'n Whistle in the over-the-counter market to cover his loans and was held to be a "statutory underwriter."[14] As such, the

10. *E.g.*, Maheu v. Reynolds Co., 282 F. Supp. 423 (S.D.N.Y. 1968); Berman v. Orimex Trading, Inc., 291 F. Supp. 701 (S.D.N.Y. 1968).

11. 15 U.S.C. § 77a et seq. (1971).

12. Section 4(2) of the 1933 Act provides:

> The provisions of Section 5 [requiring registration] shall not apply to—
> (2) transactions by an issuer not involving any public offering.

13. 501 F.2d 1279 (7th Cir. 1974).

14. Section 2(11) of the 1933 Act defines the term "underwriter" to mean:

> Any person who has purchased from an issuer with a view to, or offers or sells for an issuer in connection with, the distribution of any security, or participates or has a direct or indirect participation in any such undertaking, or participates or has a participation in the direct or indirect underwiting of any such undertaking; but such term shall not include a person whose interest is limited to

court of appeals held that Dolnick was engaged in a distribution of securities which, had they been sold by the issuer Pig'n Whistle, would have required registration. In holding Dolnick to be engaged in a distribution of unregistered securities, the court stated:

> A sale of these 500 shares in the over-the-counter market by the issuer would have constituted a "public offering" within Section 4(2). This is so because *whether an offering is public does not depend on how many shares are offered, but whether the buyer has need for the protections of the Act.* By the same token, the sale of these shares by an intermediary like Dolnick was a 'distribution' within Section 2(11).[15] (emphasis supplied)

This test is a broad one requiring not a minimal amount of thought and consideration by the securities law practitioner in advising his clients when the potential of a public offering exists. This issue will undoubtedly occupy the securities bar unless a more objective, workable definition of "public offering" is legislatively formulated.[16]

STATUTE OF LIMITATIONS

Rule 10b-5[17] promulgated by the Securities and Exchange Commission under section 10(b) of the 1934 Act[18] which deals with manipulative and deceptive conduct in connection with the purchase or sale of a security has been the breeding ground for most federal securities laws litigation. Neither the rule nor the statutory section under which

a commission from an underwriter or dealer not in excess of the usual and customary distributors' or sellers' commission. As used in this paragraph the term 'issuer' shall include, in addition to an issuer, any person directly or indirectly controlling or controlled by the issuer, or any person under direct or indirect common control with the issuer.

15. 501 F.2d at 1282. *See also* SEC v. Ralston-Purina Co., 346 U.S. 119 (1953).

16. *See* 17 C.F.R. § 230.146 (1974) (SEC Rule 146 attempted to remedy this confusion.

17. 17 C.F.R. 240.10b-5 (1971), promulgated in 1942. The rule states:

> 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
>
> (1) to employ any device, scheme or artiface to defraud,
>
> (2) 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 light of the circumstances under which they were made, not misleading, or
>
> (3) 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.

18. 15 U.S.C. § 78j(b) (1971).

> 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 as necessary or appropriate in the public interest or for the protection of investors.

it is promulgated deals with the time frame in which a private action may be brought for violation of the rule's provisions. Thus, federal courts have looked elsewhere for an appropriate period of limitations. In *Parrent v. Midwest Rug Mills, Inc.*,[19] the Seventh Circuit held that where an action is brought under section 10(b) of the 1934 Act and Illinois is the forum state, the district court should apply the three-year statute of limitations found in the Illinois Securities Law of 1953.[20] This has been termed the "resemblance test". During the past year, the court of appeals again had occasion to address itself to issues concerning the statutes of limitations with respect to actions under rule 10b-5.

In *Hupp v. Gray*,[21] the plaintiff filed his original complaint in September, 1971 seeking damages from Gray, an individual, and A.G. Becker & Co., a broker-dealer. From May 1, 1965 to January 10, 1966, Hupp made a number of purchases of shares of stock in the Variable Annuity Life Insurance Company of America (Valic) through his stockbroker, Gray, who was employed by A.G. Becker. The plaintiff alleged that he was induced to make such purchases based on material misrepresentations made to him by Gray. The price paid by Hupp for the Valic stock ranged from $24.75 per share to $47.00 per share. In the weeks after the plaintiff's last purchase at $47.00 per share, the market price of Valic stock began to drop. Thereafter, in March 1967, the plaintiff sold his Valic shares through a different broker-dealer for approximately $17.50 per share. The plaintiff claimed that he discovered Gray's alleged misrepresentations and omissions by accident in August, 1970, especially a representation with respect to the pre-eminence of Valic in the variable insurance industry. In affirming the district court dismissal of the action as being time-barred, the court of appeals held that the discovery of certain misrepresentations in August 1970 with respect to transactions completed in 1967 did not toll the statute of limitations since the equitable doctrine of fraudulent concealment could not be applied to the factual circumstances of the plaintiff's situation.

> This court recognized in *Parrent* that the statute of limitations in a Section 10(b) action may be tolled by the 'equitable doctrine' of fraudulent concealment. In order to invoke this doctrine, however, the plaintiff must have remained ignorant of the fraud, 'without any fault or want of diligence or care on his part.' It is well estab-

19. 455 F.2d 123 (7th Cir. 1972).
20. ILL. REV. STAT. ch. 121 1/2, § 137.13D (1973).
21. 500 F.2d 993 (7th Cir. 1974).

> lished that a plaintiff may not merely rely on his own unawareness of the facts of law to toll the statute. The plaintiff, rather, has the burden of showing that he 'exercised reasonable care and diligence in seeking to learn the facts which would disclose the fraud.' That statutory period [does] not await appellants' leisurely discovery of full details of the alleged scheme.[22]

The court noted that even a wholly unsophisticated investor should have realized by March 1967 when the shares purchased were sold at a substantial loss, instead of at a substantial profit as represented by the defendant broker, that something had gone awry. In light of this, and the fact that the plaintiff sold his shares through a broker other than the defendant, the court found that the plaintiff had ample opportunity and notice that something was wrong and yet he did nothing about it. While the court acknowledged that a fiduciary relationship between broker and customer should be considered in determining whether a plaintiff has exercised due diligence, the court held that where a reasonable person would have been put on notice by information reasonably available to him, this would far outweigh the fiduciary relationship factor.[23]

In *Hochfelder v. Ernst & Ernst*,[24] an action emanating from the fraudulent securities schemes described in detail in *SEC v. First Securities Co. of Chicago*,[25] the plaintiffs claimed that the defendant Ernst & Ernst, a certified public accounting firm, was negligent in auditing First Securities Co. of Chicago, thereby aiding and abetting the rule 10b-5 violations since, it was contended, had Ernst & Ernst duly executed its audit of First Securities, the fraudulent schemes would have been uncovered or prevented. The trial judge held that the applicable three-year statute of limitations had run in view of the fact that Ernst & Ernst's last audit was filed in December 1967 and the first complaint in plaintiffs' actions were not entered until February 1971. In the district court, the plaintiffs urged that the equitable doctrine of fraudulent concealment prevented the bar of the statute of limitations from beginning to run until the fraud was discovered in June 1968. The trial court rejected this tolling of the statute, holding that there was no fraudulent concealment by Ernst & Ernst. In reversing the trial court on this issue, the court of appeals held that Ernst & Ernst is to

22. *Id.* at 996. *See also* Klein v. Bower, 421 F.2d 338 (2d Cir. 1970); Bailey v. Glover, 88 U.S. 342 (1874); Morgan v. Koch, 419 F.2d 993 (7th Cir. 1969); Laundry Equipment Sales Corp. v. Borg-Warner Corp., 334 F.2d 788 (7th Cir. 1964).

23. 500 F.2d at 997.

24. 503 F.2d 1100 (7th Cir. 1974).

25. 463 F.2d 981 (7th Cir. 1972). For a valuable analysis of the *First Securities* litigation, see Horwich & Ruder, *supra* note 5, at 377.

be charged with the negligent facilitation and implementation of the fraud. Moreover, commented the court, the *First Securities* defendants, through their efforts in concealing the underlying fraud, effectively cloaked and concealed the alleged negligent facilitating conduct of Ernst & Ernst and, in the judgment of the court, the plaintiffs could avail themselves of the equitable tolling doctrine. That defendant Ernst & Ernst should be charged with negligence was determined by the court after a lengthy analysis of the standards and principles of auditing and accounting, a discussion of which is beyond the scope of this summary. Based on those standards, Ernst & Ernst, as experts in auditing and accounting, were held to be negligent in performing their auditing function, as a reasonable man could not have discovered their negligent facilitation of the fraud in *First Securities* until after the suicide of Nay, the principal architect of the fraudulent scheme. This result is fully consonant with the court's decision in *Hupp*. It is both clear and fair that the person claiming a tolling of the applicable statute of limitations be required to make a showing that no factual circumstances would have indicated, or even suggested, that a fraud was being concealed. In *Hupp,* such a catalytic factor was available for all to see in the form of the public market price. In *Hochfelder,* however, the fraudulent concealment was negligently aided and abetted by defendant Ernst & Ernst, an expert upon whose practices and procedures the plaintiffs were entitled to place substantial reliance. There was no way, but for the precipitous suicide of Nay, for the plaintiffs to discover the fraudulent concealment. The court was thus consistent in its approach to the use of the equitable tolling doctrine.

SUBSTANTIVE CONDUCT AMOUNTING TO SECURITIES LAW FRAUD

During the past year the court of appeals dealt with substantive determinations of securities law fraud as well as with what has come to be known as secondary liability under the securities laws. Secondary liability generally means liability which may result from another's violation of the federal securities laws.[26]

In *Burns v. Paddock,*[27] the Seventh Circuit Court of Appeals had

26. Brennan v. Midwestern United Life Insurance Co., 417 F.2d 147 (7th Cir. 1969), *cert. denied,* 397 U.S. 989 (1970), was probably the first case from which liability for aiding and abetting another's securities laws violation came to be accepted as an appropriate remedy. For a comprehensive discussion of aiding and abetting see Ruder, *Multiple Defendants in Securities Law Fraud Cases,* 120 U. PENN. L. REV. 597 (1972).
27. 503 F.2d 18 (7th Cir. 1974).

occasion to deal directly with the definition of securities law fraud. This action arose from the plaintiffs' purchase of a minority interest in the Paddock Corporation which they were allegedly induced to purchase by certain promises which the defendants did not intend to fulfill. The complaint alleged that in making their investments, the plaintiffs relied upon the following oral promises: that for a period of ten years, control of the company would be placed in the minority investors through the use of a voting trust; that no one would be permitted to become a director of the company unless he owned at least 1% of the company's stock; and that the plaintiffs would occupy certain important offices and positions with the company and play important roles in the management of the company. But for these promises, the plaintiffs alleged they would not have invested in the company. The district court dismissed the count of the complaint based upon these promises asserting that broken promises do not rise to the level of fraud or a violation of rule 10b-5. In reversing the district court's dismissal, the court of appeals stated:

> Where a promise is made with the intention of not keeping it, there is a scheme or artifice to defraud. This court has specifically adopted the rule that a promise made with a deceptive intent violates the Securities Act. The law has been long established that a scheme to defraud may consist of suggestions and promises as to the future when not made in good faith but with deceptive intent.[28]

The court further stated that there were sufficient allegations of the plaintiffs' reliance on the promises to withstand a motion to dismiss.

Hochfelder v. Ernst & Ernst,[29] sets forth the court's standard for stating a claim of liability for aiding and abetting solely by inaction resulting in liability under rule 10b-5. The court noted that its test for aiding and abetting liability requires a flexible standard of liability which should be amplified according to the particularities of each case.

> Accordingly, where, as here, it is urged that the defendant through action as well as inaction has facilitated the fraud of another, 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) concommitant 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, ade-

28. *Id.* at 23. *See also* Durland v. United States, 161 U.S. 306, 313 (1896); United States v. Herr, 338 F.2d 607, 610 (7th Cir. 1964).
29. 503 F.2d 1100.

> quate inquiry and the subsequent disclosure would have led to the discovery of the underlying fraud or its prevention.[30]

In reversing the district court and remanding the case for trial, the court of appeals held that the plaintiffs did state a claim of aiding and abetting a rule 10b-5 violation under the above elements.

The court in *Hochfelder* went into a detailed analysis of the standard and duty of care of accountants and auditors in the performance of their expert services. The court found that such standards were not met by defendant Ernst & Ernst. One of the contentions of the defendant was that the plaintiffs should be estopped from asserting a claim against the accounting firm by reason of audit confirmations which were signed by the plaintiffs and returned to the defendant. While the court concurred that estoppel is properly asserted as an affirmative defense to a claim of aiding and abetting a rule 10b-5 violation,[31] the court held that it cannot say as a matter of law that the facts surrounding the confirmations would estop the plaintiffs in this case.

> It is a rule of fundamental fairness whereby a party is precluded from benefiting from his own inconsistent conduct which has induced reliance to the detriment of another. That is, where a plaintiff has, with knowledge of the facts, initially conducted himself in a particular fashion, he cannot thereafter assume a posture inconsistent with such conduct to the detriment of a defendant who has acted in material reliance upon that conduct. Applying the estoppel rule to the instant case, if plaintiffs knew they were to report the escrow accounts as an exception on the confirmation and failed to do so, they ought not be heard to complain of Ernst & Ernst's failure to uncover or prevent the fraudulent escrow scheme, for the inference is strong that disclosure by plaintiffs to Ernst & Ernst of the existence of the escrow accounts would have led to the discovery of Nay's fraudulent scheme. Whether plaintiffs knew or as reasonable persons should have known that they were to report the escrow accounts as exceptions on the confirmations requests is a question to be properly discovered by the fact finder.[32]

The third area of substantive fraud to be discussed herein relates to the area of churning and excessive trading by a broker in a customer's account.[33] In general, churning signifies in the securities business the practice by a broker of advancing his own interest, i.e., his com-

30. *Id.* at 1104.

31. *See generally* Royal Air Properties, Inc. v. Smith, 312 F.2d 210, 213 (9th Cir. 1962); Straley v. Universal Uranium & Milling Corp., 289 F.2d 370 (9th Cir. 1961); Dale v. Rosenfeld, 229 F.2d 855, 859 (2d Cir. 1956).

32. 503 F.2d at 1118. *See also* Hecht v. Harris Upham & Co., 430 F.2d 1202 (9th Cir. 1970); Hampden v. Paramount Pictures Corp., 279 F.2d 100 (9th Cir. 1960).

33. *See, e.g.*, Lorenz v. Watson, 258 F. Supp. 724 (E.D. Pa. 1966).

missions based on trading volume, without regard to his customer's objectives by a course of trading which is excessive in light of the size and character of the customer's account. In *Fey v. Walston & Co., Inc.*,[34] the court reversed and remanded a churning case on the grounds that the trial court had erred in limiting the cross examination of the plaintiff customer which was designed to shed further light on her trading sophistication and her investment requirements or objectives. The plaintiff, a widow, testified that she had been employed since her husband's death in 1956, and had been left little or no assets. In November 1963, she had eleven or twelve thousand dollars which she had accumulated in part through some investments. During cross examination, it was brought out that the plaintiff had dealt on a number of occasions with broker-dealers other than the defendant. While the court held that there was substantial credible evidence supporting the verdict of the jury in favor of the plaintiff on the issue of liability, the court stated that the district court had unduly limited inquiry as to the plaintiff's investment requirements or objectives.

> In a churning case, the independent objectives of a customer are an important standard against which to measure claimed excessiveness. Certainly evidence bearing upon the experience, sophistication or trading naivete of the customer may be highly significant. Despite the trial court's early impression that the sole question was one of authority and plaintiff's initial testimony that the trades in question were without her authority, some of her later testimony supported the theory of abuse of authority through churning. The trial court, inconsistent with evidential developments in the case applied discriminately against the defendants from time to time its initial erroneous view and precluded full exploration by the defendants of plaintiff's continuing churning theory.[35]

The court noted that the trial judge's instructions somewhat obscured the fact that liability could accrue should the securities salesman fail to conform to the customer's objectives, but if a salesman does only what the customer has independently in mind as an objective, has authority to do so and fulfills the fiduciary duty to furnish fair advice, the additional motive of the salesman to earn commissions does not convert the transactions into a violation of rule 10b-5.

The plaintiff Fey relied, at least in part, upon the alleged abuse

34. 493 F.2d 1036 (7th Cir. 1974).

35. *Id.* at 1045. *See also* Booth v. Peavey Company Commodities Services, 430 F.2d 132 (8th Cir. 1970); Hecht v. Harris Upham & Co., 430 F.2d 1202 (9th Cir 1970); Newberger, Loeb & Co. v. Gross, 365 F. Supp. 1364 (S.D.N.Y. 1973); Moscarelli v. Stamm, 288 F. Supp. 453 (E.D.N.Y. 1968). *See generally* Note, *Churning by Securities Dealers*, 80 HARV. L. REV. 869 (1967).

by her broker of a fiduciary relationship for her claim of churning of her account. The court stated that the mere existence of a broker-customer relationship is not proof of its fiduciary character, but on a disputed record the issue remains one of fact. Had it been shown that the plaintiff relied heavily upon the defendant broker with respect to her investments rather than the trial court having limited inquiry into her investment expertise, the issue of fiduciary relationships would have been resolved more easily.

The question of estoppel was raised here in a manner similar to that in *Hochfelder*. Here the court stated:

> Mere failure to read statements and confirmation, or to object to actions revealed therein, could not be deemed sufficient as a matter of law to establish waiver or to raise an estoppel in view of plaintiff's theory of fiduciary relationship and related impositions by defendants. Express consent to churning transactions would not necessarily raise these defenses if such consent were induced by the undue influence of a fiduciary. Indeed, it has been said that transactions initiated by the customers themselves may be indicative of churning where the trust and confidence of the customer vests control in the broker.
>
> The vice of churning is not to be localized within a particular transaction. It is the aggregation of transactions excessive in number and effect which constitutes the gravamen of the complaint. One consenting to a particular sale may not by that token agree to a proliferation of similar sales, especially if dealing with a fiduciary in whom there is a right to repose confidence. On the other hand, lack of knowledge of various rights may not be supportive of, or even germane to the claim of one who independently initiates, or freely and fairly approves, a series of transactions which would constitute churning if induced by an agent for fraudulent purpose.[36]

Under the particular circumstances in *Fey*, the court of appeals stated that it believed proper submission of the issues framed by the complaint and the general denials would have permitted the jury to fairly consider whether any excessive trading was attributable to the defendants. The jury could determine if the abuse of authority or undue influence arose from the fiduciary relationship, or if the plaintiff was independently motivated to trade excessively as dictated by her own objectives and desires. As a result, the matter was remanded for a new trial to grant the defendants the opportunity to explore these issues more fully before the fact finder, notwithstanding the likelihood of some liability on the part of the defendants.

36. 493 F.2d at 1049.

DAMAGES IN SECURITIES ACTIONS

Another issue which the court of appeals faced during this past year was the issue of damages in securities actions. *Madigan, Inc. v. Goodman*,[37] was an action for alleged fraudulent misrepresentation in connection with the purchase by the plaintiffs of stock of an insurance company which later failed. According to the complaint, the plaintiffs purchased all the outstanding stock of Fidelity General Insurance Company from seven former shareholders in two steps, for which they paid over three million dollars. The plaintiffs asserted that as a result of the material misrepresentations, in addition to the loss of the purchase price, they had expended additional sums in an effort to prevent the insolvency of the insurance company, lost one million dollars in expected profits, incurred substantial expenses in defending lawsuits resulting from their purchase of the stock, might incur substantial additional losses in connection with the insurance company related litigation and were unable to plan and conduct their financial affairs in an orderly manner due to this litigation. Agreeing with the plaintiffs with respect to consequential damages, the court stated that if the plaintiffs can establish the requisite causal nexus at trial, they are entitled to recover out-of-pocket consequential damages suffered as a result of holding the insurance company stock.[38] The court rejected the contention that consequential damages are recoverable only if incurred while the stock was held.

> When a securities transaction causes plaintiffs to wind up with less money than they began with, there is no reason in the policies of the securities laws why their right to recovery should depend on exactly when the loss was realized or on whether the loss was fully reflected on a change in the securities price. Accordingly, capital contributions and other expenses of attempting to save Fidelity may be recoverable. Plaintiffs must show that each expenditure for which recovery is sought is a reasonable effort to, e.g., minimize plaintiffs' losses, or fulfill a fiduciary obligation to Fidelity policy holders, or comply with the requirements of regulatory agencies. They must also show that the danger from which Fidelity was being saved was the pre-existing insolvency concealed by defendnats, and that but for defendants' misrepresentations, plaintiffs would not have made these expenditures. We also think that the $18,384 broker's commission, or finder's fee, is recoverable if, but for the misrepresentations, it would not have been spent.[39]

37. 498 F.2d 233 (7th Cir. 1974).
38. *See also* Zeller v. Bogue Electric Manufacturing Corp., 476 F.2d 795 (2d Cir. 1973), *cert. denied*, 414 U.S. 908 (1974).
39. 498 F.2d at 238-39.

The court went on to say that damages which are not a direct consequence of the alleged fraud would not be recoverable.

> The federal rule has traditionally been that only 'out-of-pocket' losses are recoverable in a fraud action. A defendant was bound to make good the loss sustained, such as the monies the plaintiff had paid out and interest and any other outlay legitimately attributable to the defendants' fraudulent conduct; but this liability did not include the expected fruits of an unrealized speculation.[40]

Thus, the court of appeals reversed the trial court order insofar as it denied the plaintiffs the opportunity to prove their right to direct consequential damages.

It would seem that this result is a correct one since securities law fraud can be deemed akin to an action in tort. As the court in *Madigan* noted, the plaintiffs did not allege breach of contract, rather, they alleged misrepresentation. If the defendants had told the truth, the plaintiffs would have no complaint, since, had the defendants acted legally, the plaintiffs would not have purchased the stock of the now defunct insurance company, or at least would have purchased it at a lower price. Thus, the plaintiffs should be entitled to compensation for lost alternative uses of their money, that is, direct consequential damages, but not for profits that never existed.

TECHNICAL VIOLATIONS OF THE REPORTING REQUIREMENTS

Section 13(d) of the 1934 Act[41] requires the timely filing of a

40. *Id.*
41. 15 U.S.C. § 78m(d) (1971).

(d)(1) Any person who, after acquiring directly or indirectly the beneficial ownership of any equity security of a class which is registered pursuant to section 12 of this title, or any equity security of an insurance company which would have been required to be so registered except for the exemption contained in section 12(g)(2)(G) of this title, or any equity security issued by a closed-end investment company registered under the Investment Company Act of 1940, is directly or indirectly the beneficial owner of more than 5 per centum of such class shall, within ten days after such acquisition, send to the issuer of the security at its principal executive office, by registered or certified mail, send to each exchange where the security is traded, and file with the Commission, a statement containing such of the following information, and such additional information, as the Commission may by rules and regulations prescribe as necessary or appropriate in the public interest or for the protection of investors—

(A) the background and identity of all persons by whom or on whose behalf the purchases have been or are to be effected;

(B) the source and amount of the funds or other consideration used or to be used in making the purchases, and if any part of the purchase price or proposed purchase price is represented or is to be represented by funds or other consideration borrowed or otherwise obtained for the purpose of acquiring, holding or trading such security, a description of the transaction and the names of the parties thereto, except that where a source of funds in a loan made in the ordinary course of business by a bank, as defined in section 3(a)(6) of schedule 13D with the Securities and Exchange Commission upon the acquisition of 5% of the outstanding securities of an class of a corporation registered under the 1934 Act. In *Mosinee Paper Corp. v. Rondeau*,[42] the defendant conceded his technical violation of this require-

this title, if the person filing such statement so requests, the names of the bank shall not be made available to the public;

(C) if the purpose of the purchasers or prospective purchaser is to acquire control of the business of the issuer of the securities, any plans or proposals which such persons may have to liquidate such issuer, to sell its assets to or merge it with any other persons, or to make any other major change in its business or corporate structure;

(D) the number of shares of such security which are beneficially owned, and the number of shares concerning which there is a right to acquire, directly or indirectly, by (i) such person, and (ii) by each associate of such person, giving the name and address of each such associate; and

(E) information as to any contracts, arrangements, or understandings with any person with respect to any securities of the issuer, including but not limited to transfer of any of the securities, joint ventures, loan or option arrangements, puts or calls, guaranties of loans, guaranties against loss or guaranties of profits, division of losses or profits, or the giving or withholding of proxies, naming the persons with whom such contracts, arrangements, or understandings have been entered into, and giving the details thereof.

(2) If any material change occurs in the facts set forth in the statements to the issuer and the exchange, and in the statement filed with the Commission, an amendment shall be transmitted to the issuer and the exchange and shall be filed with the Commission, in accordance with such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

(3) When two or more persons act as a partnership, limited partnership, syndicate, or other group for the purpose of acquiring, holding or disposing of securities of an issuer, such syndicate or group shall be deemed a 'person' for the purposes of this subsection.

(4) In determining, for purposes of this subsection, any percentage of a class of any security, such class shall be deemed to consist of the amount of the outstanding securities of such class, exclusive of any securities of such class held by or for the account of the issuer or a subsidiary of the issuer.

(5) The Commission, by rule or regulation or by order, may permit any person to file in lieu of the statement required by paragraph (1) of this subsection or the rules and regulations thereunder, a notice stating the name of such person, the number of shares of any equity securities subject to paragraph (1) which are owned by him, the date of their acquisition and such other information as the Commission may specify, as it appears to the Commission that such securities were acquired by such person in the ordinary course of his business and were not acquired for the purpose of and do not have the effect of changing or influencing the control of the issuer nor in connection with or as a participant in any transaction having such purpose or effect.

(6) The provisions of this subsection shall not apply to—

(A) any acquisition or offer to acquire securities made or proposed to be made by means of a registration statement under the Securities Act of 1933;

(B) any acquisition of the beneficial ownership of a security which, together with all other acquisitions by the same person of securities of the same class during the preceding twelve months, does not exceed 2 per centum of that class;

(C) any acquisition of an equity security by the issuer of such security;

(D) any acquisition or proposed acquisition of a security which the Commission, by rules or regulations or by order, shall exempt from the provisions of this subsection as not entered into for the purpose of, and not having the effect of, changing or influencing the control of the issuer or otherwise as not comprehended within the purposes of this subsection.

42. 500 F.2d 1011 (7th Cir. 1974).

ment by not timely filing a schedule 13D after having purchased 8% of the outstanding common stock of the plaintiff corporation. The defendant claimed that his failure to timely file schedule 13D was merely a technical violation of the law which was cured by his subsequent late filing. The purpose of the filing requirement, that of providing adequate notice and information to the management and shareholders regarding an individual or group seeking control of a corporation prior to a tender offer or proxy contest, was met within a reasonable time. Summary judgment for the defendant was reversed and the court of appeals ordered the district court to prohibit defendant Rondeau from voting 3% of the outstanding shares of Mosinee Paper Corporation with respect to any take-over, proxy contest, or vote for officers and membership in the board of directors for a period of five years. The majority of the court of appeals panel felt that this injunctive decree was appropriate to neutralize the defendant's violation of the act and to deny him the benefit of his wrongdoing. In reaching this conclusion, the majority opinion held that the purpose for the reporting requirements of section 13(d) relates, not to the intention of the acquiring party, but rather, to the potential to effect control.

> We agree with the Second Circuit's analysis of the Act . . . that 'the purpose of Section 13(d) is to alert the market place to every large rapid aggregation or accumulation of securities, regardless of technique employed, which might represent a potential shift in corporate control. . . .' To this observation we add what is self-evident from the language and legislative history of the Williams Act, the reporting requirements of Section 13(d) apply regardless of the purchasers' purpose in acquiring his shares.[43]

In his dissent, Judge Pell noted:

> The Williams Act by its terms does not provide any penalties for its violation, nor does it mandate any civil remedy. While I would not gainsay that the courts may properly fashion a remedy for a violation of the act, I could not conceive that Congress intended the punishment should do otherwise than fit the crime. Therefore, assuming there was no genuine issue of material fact presented to the district court, a separate issue which does cause me concern, I am unable to concur in the result reached by the majority.[44]

Judge Pell went on to carefully reason that, indeed, the violation of the reporting requirements did not cause irreparable harm and further that the injunctive order punishment of the majority certainly did not

43. *Id.* at 1016. *See also* GAF Corporation v. Milstein, 453 F.2d 709, 717 (2d Cir. 1971).
44. 500 F.2d at 1018.

fit the crime. While the majority opinion in *Mosinee* is a proper effort in attempting to further compliance with one of the myriad reporting requirements under the federal securities laws, it would seem that under the circumstances presented in the case, Judge Pell's dissent is clearly the better reasoned and more equitable view.

CONCLUSION

The Court of Appeals for the Seventh Circuit, while not as heavily ladened with securities actions as, say, the Second Circuit, has over the years been involved in many novel developments under the federal securities laws. The cases decided by the Seventh Circuit in this area during the past year on balance generally seem to have been consistent with both fundamental fairness and the court's prior pronouncements. Securities lawyers practicing within the jurisdiction of the Seventh Circuit Court of Appeals are generally fortunate in finding usually well reasoned judicial decisions in the securities law area. This added measure of relative predictability should serve the Seventh Circuit securities bar well in dealings with and on behalf of its clients.