SECURITIES LAW

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As had been observed, the Seventh Circuit has been one of the more active circuits in the area of securities regulation and is responsible for several of the leading decisions in the field. Once again, the Seventh Circuit has handed down several decisions of interest to practitioners in the area of securities regulation, particularly C.N.S. Enterprises, Inc. v. G. & G. Enterprises, Inc., relating to the circumstances under which a note is not a security, and Northway, Inc. v. TSC Industries, Inc., dealing with the test for materiality with respect to a misleading proxy statement. However, this year, of primary interest is not so much what the Seventh Circuit has done, but rather what the Supreme Court has done to the Seventh Circuit. This article will begin by reviewing two earlier decisions of the Seventh Circuit and analyzing the recent decisions of the United States Supreme Court which have reversed, explicitly or implicitly, these Seventh Circuit opinions.

THE EASON AND BLUE CHIP STAMPS DECISIONS

In 1973, the Seventh Circuit decided Eason v. General Motors Acceptance Corp. and in 1974, the Supreme Court denied certiorari. Eason dealt specifically with the so-called “Birnbaum Rule” and explicitly held that this rule was “not part of the law of this circuit.” Moreover, Eason was heralded as signaling the ultimate demise of Birnbaum.

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2. Horwich & Ruder, note 1 supra, at 362-63.
3. 508 F.2d 1354 (7th Cir. 1975).
4. 512 F.2d 324 (7th Cir. 1975).
5. 490 F.2d 654 (7th Cir. 1973).
7. The Birnbaum rule was articulated by Judge Augustus Hand in Birnbaum v. Newport Steel Corp., 193 F.2d 461, 464 (2d Cir. 1952) where he stated, in interpreting rule 10b-5 promulgated pursuant to section 10b of the 1934 Securities Exchange Act, that “that section was directed solely at that type of misrepresentation or fraudulent practice usually associated with the sale or purchase of securities rather than at fraudulent mismanagement of corporate affairs, and that [r]ule X-10B-5 extended protection only to the defrauded purchaser or seller.”
8. 490 F.2d at 651.
Simply stated, the *Birnbaum* rule is a standing requirement which would limit the scope of protection afforded by rule 10b-5, promulgated by the Securities Exchange Commission (SEC) pursuant to section 10(b) of the 1934 Securities and Exchange Act, to those persons who are either defrauded purchasers or defrauded sellers. Rule 10b-5 prohibits the use of interstate instrumentalities to defraud someone "in connection with the purchase or sale of any security." It should be noted that the rule does not specifically require that the plaintiff be a purchaser or seller of securities. Rather, the rule merely requires that the persons be defrauded "in connection with" a purchase or sale of securities. In the years since *Birnbaum* was enunciated, many decisions have either distinguished or rejected the application of the rule. The courts, over the years, have encountered many situations in which a person was injured in a transaction which "involved" or "touched" the sale of securities and where the plaintiff was neither, strictly speaking, a purchaser or seller of securities. In some circumstances, the extension of the application of rule 10b-5, to view it one way, or the circumvention of *Birnbaum*, to look at it another way, was not a difficult step. For example, it is clear that the rule protects the defrauded issuer of securities, even though, strictly speaking, the issuer does not sell but rather engages in the legally cognizable act of "issuing" the securities. The Supreme Court itself


12. The complete text of rule 10b-5, 17 C.F.R. § 240.10b-5 (1975), is as follows:
   (a) to employ any device, scheme, or artifice to defraud,
   (b) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
   (c) to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person in connection with the purchase or sale of any security.

16. Issuance is the act by which a corporation creates fractional, proprietary interest in itself. It is interesting to note that this term is generally not defined. For example, the 1933 Securities Act defines "issuer" as a person who issues or proposes to issue any security, but it does not define issue. Similarly, the Uniform Commercial Code [ILL. REV. STAT., ch. 26, § 8-201 (1) (1973)] defines "issuer" but again does not define "issue". However, subparagraph (b) which defines an issuer to be a person who "directly or indirectly creates fractional interests in his rights or property which fractional interests are evidenced by securities" implicitly gives the definition of the process
held that the recipient of new securities in a merger was in effect a seller of securities. It is with this background of "end-runs" that the Seventh Circuit confronted the facts of *Eason*.

In *Eason*, a corporate purchaser of a business issued 7,000 shares of its stock to the defendant seller, obtained the assets of the business in question and assumed the liabilities of the defendant seller. These liabilities were in large measure represented by notes from the defendant to General Motors Acceptance Corporation, which provided the financing for the automobile leasing business in question. Plaintiffs were shareholders of the corporate purchaser and, in connection with the transaction, delivered a guarantee of the notes assumed by the corporate purchaser to General Motors Acceptance Corporation, which was also made a defendant in the action. The transaction is depicted in Figure 1.

![FIGURE 1]

The business failed and the corporate purchaser became insolvent and defaulted on the notes. To forestall GMAC’s suit on the guarantee, plaintiff shareholders brought suit seeking recision of the notes on the ground that both the seller of the business and GMAC were guilty of fraud in connection with the initial sale of the business.

In order to sustain federal jurisdiction under rule 10b-5, three possible courses of action were open to the court: (1) Plaintiffs’ guarantees could have been treated as securities, in which case the plaintiffs would have no problem with standing under the *Birnbaum* rule since they would be the...
sellers or "issuers" of the securities; (2) plaintiffs could have been treated as the indirect sellers of the securities issued by the corporation purchasing defendant's business, in effect, piercing the corporate veil; and (3) the Birnbaum rule could have been rejected outright and another test applied to determine whether plaintiff shareholders were among the class of persons intended to be protected by Rule 10b-5. The Seventh Circuit, in probably the clearest and most concise treatment of this problem to date, adopted the third course of action.

According to the court, there were three aspects to the question of plaintiffs' right to relief: Whether they had "standing"; whether they were protected by the rule; and whether overriding considerations of policy defeated their claim. The standing aspect posed no great difficulty for the court. It focused upon the "injury in fact" aspect of standing and satisfied itself that the plaintiffs had a vital stake in the outcome of the controversy in question, thereby meeting the standing requirement of the rule. In point of fact, the Supreme Court has articulated a two-fold test for standing, requiring both "injury in fact" and that the complainant is within the zone of interest sought to be protected by the statute or rule in question. While the Seventh Circuit did not treat the second element in its discussion of standing, it devoted a substantial part of its analysis to the question of whether plaintiffs were within the category of persons to whom protection was intended under rule 10b-5. There is obviously a direct correlation between the "zone of interests" concept and the "persons protected" concept.

In the view of the Seventh Circuit, limiting the words "any person" in the rule so as to exclude all those except purchasers or sellers would not constitute a broad and flexible interpretation of the rule as mandated by the United States Supreme Court in several prior decisions. On the other hand, stretching the definition of "purchaser" or "seller" to the extent done in other decisions would constitute a lack of intellectual integrity.

18. This would be analogous to the approach taken in James v. Gerber Products Co., 483 F.2d 944 (6th Cir. 1973), where the beneficiary of a trust, as the real party in interest, was considered the seller and given standing to sue in a situation in which the trust itself sold stock to the issuing corporation at a price substantially below the fair market value.
21. 490 F.2d at 659. The characterization by Judge Stevens is certainly a supportable one. See, e.g., A.T. Brod & Co. v. Perlow, 375 F.2d 393 (2d Cir. 1967), where the court held that a customer's order to his broker was a contract of purchase by the customer, thereby making the broker a seller within the meaning of the Birnbaum rule and giving him standing to sue under rule 10b-5 when the customer refused to pay for the stock, having intended to pay for it only if the value of the stock increased by the
court took as its charge a directive of the Supreme Court that form should be disregarded for substance and the emphasis should be on economic reality.\textsuperscript{22}

The court focused upon the fact that the rule was designed for the protection of the investors.\textsuperscript{23} According to the court, plaintiff shareholders, who executed the guarantee in question, were clearly investors. It was their interest as stockholders in the purchasing corporation that induced them to execute the guarantees in question. With respect to the supposedly fraudulent transaction, namely, the sale of the business to the purchasing corporation and the assumption by it of the liabilities of defendant, they were directly involved. It would appear that the fact situation in \textit{Eason} was a more appropriate context to uphold the applicability of rule 10b-5 than was the fact situation in \textit{Superintendent of Insurance v. Bankers Life & Casualty Co.},\textsuperscript{24} where the Supreme Court upheld a rule 10b-5 claim and stated the test that plaintiff must have suffered injuries as a result of deceptive practices "touching its sale of securities as an investor."\textsuperscript{25} In \textit{Bankers Life}, the fraud was not in the sale of the securities themselves, but resulted from the subsequent misappropriation of the proceeds which was contemplated at the time of the sale. Thus, \textit{Bankers Life} was not a situation where the corporation was defrauded into selling securities at a low price or in selling securities which ought to have been retained; there was nothing wrong with the sale itself. It was the sale coupled with the intention at the time of sale to misappropriate proceeds that was wrongful. Thus, the best the Supreme Court could do in upholding the 10b-5 action was to state that the fraud "touched" the sale of the securities. If a rule 10b-5 cause of action is appropriate under those circumstances, it would seem \textit{a fortiori} to be all the more appropriate when the fraud is unquestionably in connection with the sale of the security and the sale transaction "-touches" the plaintiffs as direct participants in the transaction in question, though not in the capacity of purchaser or seller. In the opinion of this writer, where there is a sale (or purchase) and fraud in connection therewith, any person who is directly affected thereby should have standing to sue under rule 10b-5.

The Seventh Circuit concluded its analysis in \textit{Eason} with consideration of the question whether the Birnbaum rule should nonetheless be adopted to curtail the amount of litigation sweeping the federal courts and to promote consistency among the circuits in the interpretation of the securities acts. Neither argument was found persuasive by the court. With respect to

\textsuperscript{23} 490 F.2d at 659.
\textsuperscript{24} 404 U.S. 6 (1971).
\textsuperscript{25} \textit{Id.} at 12-13.
delimiting the amount of litigation premised upon violations of rule 10b-5, the court was of the opinion that its "special class" approach, coupled with the requirement of injury as a direct consequence of the violation, would provide adequate constraint on the types of suits which may be brought. With respect to the consistency question, the court opined that any consistency now existing is more apparent than real. Unfortunately, the court did suggest that the way to obtain consistency was for the Supreme Court to resolve the conflict among the circuits which, apparently, the Supreme Court has done in its ill-conceived opinion in Blue Chip Stamps v. Manor Drug Stores.26

In Blue Chip Stamps, the Supreme Court was confronted with a rather unusual fact situation: an involuntary public offering. The corporation, as a result of an antitrust decree, was required to offer a substantial block of shares at, arguably, a very advantageous price to retailers who had used the stamp service in the past but who were not then shareholders of the company. Nine retailers owned about 90 percent of the stock and, accordingly, it was not to their benefit to have the stock offered to others at a favorable price. The plaintiffs were retailers to whom the stock was offered but who declined to buy as a result of the "fraudulently" pessimistic statements in the registration statement. This then was the converse of the situation with which the courts are normally confronted, namely where the corporation, in an effort to sell its shares, issues an unduly optimistic registration statement.27

The fact situation in Blue Chip Stamps has elements that are both similar and dissimilar to the fact situation in Eason. Just as in Eason, plaintiffs were neither purchasers nor sellers of stock. The plaintiffs in Blue Chip Stamps alleged that they would have been purchasers had there not been fraud in the preparation of the unduly pessimistic registration statement. Unlike Eason, the problem of damages was amorphous. In Eason, plaintiffs were liable on a $300,000 guarantee if the guarantee was valid. They either were liable or they were not. In Blue Chip Stamps, there was a possibility that, had the registration statement been perfectly neutral in its disclosure, neither overly optimistic nor overly pessimistic, plaintiffs might have bought none, some, or all of the stock offered to them. But even in Blue Chip Stamps, the damage element was not quite as open as the example, suggested by Justice Rehnquist in his majority opinion, of an offering to the "whole world" in which thousands of people might later allege that had the registration statement been less pessimistic they would have purchased the offered shares.

In a divided opinion, the Supreme Court decided to adopt the Birnbaum rule. There were essentially three bases for the Court's decision: (1) The twenty-some years of judicial and legislative approval of the rule; (2) the language of the statute and the rule itself; and (3) policy considerations, primarily with the threat of vexatious litigation.

The first two reasons were generally treated together and the Court itself recognized that it was not "able to divine from the language of section 10(b) the express 'intent of congress' as to the contours of a private cause of action under [r]ule 10b-5."28 The courts, as has already been pointed out,29 have been uniquely able to circumvent the Birnbaum rule in those instances where it would work an injustice if applied.

While Congress has not acted, and thus arguably has acquiesced in the Birnbaum rule, it is far more appropriate, because of the complicated milieu in which the securities laws operate, to assume Congress left to the SEC and the courts the task of establishing the contours to a rule rather than seeking to impart specificity through congressional action. As has been amply demonstrated with regard to the question of what constitutes a security, those who flourish on the edge of the law are quick to concoct schemes designed to slip within the letter but not the spirit of the law.30 Thus, to flesh out a regulatory statute dealing with such a complex and variegated field as securities, some "catch-all" provision is needed and it was to this end that section 10(b) was enacted and rule 10b-5 promulgated.31

Moreover, the language of the rule itself, with the "in connection with" language, certainly does not compel the conclusion that one must be a purchaser or seller himself in order to be within the language of the rule. In effect, the Brinbaum rule rewords rule 10b-5 to provide that "any person in connection with a purchase or sale by him who is defrauded through the use of interstate instrumentalities may sue. It is just as reasonable to read the rule

28. 421 U.S. at 737.
30. As the Supreme Court stated in SEC v. W.J. Howey Co., 328 U.S. 293, 299 (1946), the definition of a security "embodies a flexible rather than a static principle, one that is capable of adaptation to meet the countless and variable schemes devised by those who seek the use of the money of others on the promise of profits." And, as Lewis Lowenfels stated in arguing against the perpetuation of the Birnbaum doctrine:

The infinite variety of problems which the courts are called upon to consider, the many varieties and complexities of fraud which are possible in contemporary securities markets, the ingenuity of potential wrongdoers—all argue strongly against having any rigid, inflexible judicial requirement other than the presence of the fraud itself as a sine qua non of the right to sue. If such a rigid doctrine is permitted to exist, clever men will always find ways to perpetrate their wrongdoing without incurring liability.

31. See Blue Chip Stamps v. Manor, 421 U.S. 723, 765-66 (1975) (Blackmun, J., dissenting), and the legislative history relied upon therein.
as providing that "any person who is injured in connection with the purchase or sale of a security" may sue. Thus, neither the wording of the rule itself nor the legislative or judicial history compels the conclusion reached by the Supreme Court.

It would seem to this writer that an honest reading of Blue Chip Stamps would result in the conclusion that the dominant reason for the decision of the Court was a desire to delimit the burgeoning litigation involving rule 10b-5 and to avoid vexacious litigation by permitting certain types of "undesirable" litigation to be terminated early in the pleading stage and prior to the onset of disruptive discovery. Justice Rehnquist devoted considerable space to a discussion of vexacious litigation in which, as a result of liberal pleading rules, a plaintiff who has little chance of prevailing on the merits can put himself in a posture to be able to resist dismissal or summary judgment and harass the corporate defendant through the discovery process, thereby developing a settlement value out of proportion to the merits of the claim. Justice Rehnquist was also concerned over the extent to which proof of the claim depended upon oral testimony with little objective corroboration and the open-endedness of the potential judgments.

The "parade of horribles" approach to decision making has always struck this writer as a weak basis upon which to build public policies. In point of fact, the dangers inherent in the examples offered by the Court may be more apparent than real. The Court pointed out that the stock of issuers is listed on financial exchanges utilized by millions of investors and that corporate representations reach millions more, not just through the financial journals but also through the nation's daily newspapers. However, SEC v. Texas Gulf Sulphur Co. has already established that those who sell as a result of a gloomy press release do have a cause of action for damages. This situation is, of course, within the Birnbaum rule. The converse of Texas Gulf Sulfur has been effectively foreclosed by the Court in Blue Chip Stamps: persons who, not owning any stock in Texas Gulf Sulphur, might claim that they would have bought stock in Texas Gulf Sulphur had there not been a misleading press release may not now sue. Thus the Birnbaum rule does effectively delimit the scope of claims against corporations in this context.

A better, though obviously less definite, approach to this problem would seem to be the one articulated by the Seventh Circuit in Eason. The court required both that the plaintiff be within the "special class" protected by the rule and that his injury be a "direct consequence" of the alleged violation. In other words, since the general investor has so many investment options open to him over an undifferentiated time continuum, the Seventh Circuit

32. Id. at 741.
33. 401 F.2d 833 (2d Cir. 1968).
34. 490 F.2d at 660.
would require that he establish "but for" the dissemination of the fraudulently pessimistic information in question, he would have purchased the stock of the corporation in question. Put another way, he would have to establish that he was about to make an investment decision at some point in time, that he had the financial wherewithal to consummate the purchase in question and that he would have invested in the particular issuer had it not disseminated the gloomy material. Thus, the "horribles" envisioned by the Supreme Court could be handled on the basis of lack of causation rather than on the basis of standing.

In _Blue Chip Stamps_ the plaintiff might well have been able to meet these tests because the offer in question was a differentiated offer to particularized persons required by the consent decree. Moreover, the plaintiffs already had an economic interest in the corporation as a result of the vendor-vendee relationship. The _Blue Chip Stamps_ plaintiff would still need to establish that he had the economic wherewithal to make the purchase (the number of shares which he could buy was limited by the consent decree itself) and that the pessimistic statements were sufficiently material to affect his investment decision.

Turning again to _Eason_, causality requirements most certainly could have been met there since the plaintiff obviously would not have issued his guarantee unless the controlled corporation was issuing its stock. Thus, if the issuance of stock was fraudulently induced, so also was the guarantee.

The Supreme Court recognized that some noble plaintiffs might be foreclosed from the federal courts by its imposition of the _Birnbaum_ rule but thought that the number so affected would be so small that the detriment would be more than outweighed by the benefit in avoiding vexacious litigation and open-ended claims. The three classes envisioned by the Supreme Court were as follows:35 (1) Potential purchasers, either in the distribution or trading markets, who alleged they did not purchase because of the gloomy representations; (2) actual shareholders who alleged they decided not to sell because of unduly optimistic representations or failure to disclose unfavorable material; and (3) shareholders, creditors and perhaps others related to the issuer who suffered loss as a result of insider activities in connection with the purchase or sale of securities. With respect to the first example, this article has already suggested that the "but for" or causality requirement may be sufficient to limit the instances in which rule 10b-5 is applicable, though admittedly this approach does not lend itself to resolution at the pleading stage and would probably require the advent of discovery activity.

In regards to the second illustration, if there is no sale at all, even absent the _Birnbaum_ rule, there is no basis for a 10b-5 action under the law

35. 421 U.S. at 737.
as it now stands except in a prophylactic, injunctive type proceeding.\textsuperscript{36}

With respect to the third illustration, if the shareholders or creditors in question can bring themselves within the "special class" rule and establish the causal connection between the purchase or sale in question and their activity, there is no reason why a cause of action under rule 10b-5 should not lie.

The Supreme Court rationalized its approach on the basis that often a derivative action in favor of the corporation will lie if the corporation is itself a purchaser or seller of securities. While this may be true in many instances, \textit{Eason} is an excellent illustration of a situation where the derivative action may be of no value to the injured plaintiff. In \textit{Eason}, the corporation (which issued its shares because of an allegedly false representation) itself became insolvent. Accordingly, any recovery by the corporation could be consumed by creditors of the corporation with the result that the funds available for distribution to the shareholders upon liquidation of a corporation would not be sufficient to compensate them for the amounts paid out on the guarantees.

With respect to the GMAC notes assumed by the corporation acquiring defendant's business and guaranteed by the plaintiff shareholders, it is arguable that if the corporation (which issued securities in the transaction) can rescind its assumption of the notes, then the guarantors should be able to join in the suit and the guarantee of the notes should fall. However, it is questionable whether the doctrine of pendent jurisdiction, coupled with the existence of the \textit{Birnbaum} rule, would permit a plaintiff separate and distinct from the corporation to couple his claim with the corporation's in a federal court action. Although there is a split among the circuits on this issue, pendent jurisdiction properly relates to joinder of claims, not joinder of parties.\textsuperscript{37} From a jurisdictional standpoint, it is one thing to permit a party properly in court to add another count to his complaint but it is quite another to permit a person who has no federal cause of action to piggyback jurisdiction.

Another area where the application of the \textit{Birnbaum} doctrine may either work an inequity or force the courts to adopt strained constructions of 36. Mutual Shares Corp. v. Genesco, Inc., 384 F.2d 540 (2d Cir. 1967). The Securities and Exchange Commission may also sue for injunctive relief without there having actually been as yet a purchase or sale.

37. The question of whether the doctrine of pendent jurisdiction is broad enough to give federal courts power over additional parties has not yet been resolved. See Moor v. County of Alameda, 411 U.S. 693 (1973), where Mr. Justice Marshall distinguished United Mine Workers v. Gibbs, 383 U.S. 715 (1966), on the basis that in \textit{Moor} the exercise of pendent jurisdiction "would bring us to bring an entirely new party—a new defendant—into each litigation." However, the Second Circuit has permitted pendent jurisdiction over related claims by additional parties. See Leather's Best, Inc. v. S.S. Mormaclynx, 451 F.2d 800 (2d Cir. 1971).
"who is a seller" occurs in the merger situation. The Supreme Court, in *SEC v. National Securities, Inc.*, held that where the acquiring corporation had obtained control of the target corporation's board and caused the target corporation to issue a misleading proxy statement in order to secure shareholder approval of the merger, the target company's shareholders "purchased" shares in the new company by exchanging their old stock for the new shares. But what if, instead of the format used, the acquiring corporation had been merged into a target corporation. In other words, what if the minnow had swallowed the whale.

The Supreme Court in *National Securities* recognized that there would be a sale in such circumstances—but the sale would have been by the shareholders of the acquirer who, rather than being the injured parties in the transaction, were the real culprits. In the latter circumstance, the injured parties are those shareholders, namely of target corporation, who have not sold their shares. Their approval of the transaction was obtained through the misleading proxy statement. But they retained their shares.

While it may be that rule 14a-9 may provide a remedy, that fact alone should not foreclose a rule 10b-5 action because, just as was the case in *National Securities*, the transaction might involve a company not subject to the proxy solicitation rules.

It could be argued, just as it was in *Farris v. Glen Alden Corp.*, that form should be ignored and that the true sellers of shares were the shareholders of the target corporation, notwithstanding the fact that they held the same certificate both before and after the transaction. On the other hand, rather than straining to treat "non-sellers" as sellers, it would seem to make more sense merely to hold that the merger transaction involves a purchase or sale of securities and, if the consummation of the merger was accomplished through fraud in the solicitation of proxies, that the fraud "touched" the sale of securities and those consequentially injured thereby have standing to sue. This was the approach of the Seventh Circuit in *Eason*, an approach whose luster has not been dimmed by the cloud cast by the Supreme Court in *Blue Chip Stamps*, even though its legal effect has been undercut.

39. Id. at 467.
40. Upside down mergers—where the smaller company "acquires" the larger company—are not that uncommon. While they sometimes occur in the parent-subsidiary context, they have also in effect occurred where two independent companies are involved. For example, in *Farris v. Glen Alden Corp.*, 393 Pa. 427, 143 A.2d 25 (1958), the court stated that, notwithstanding the form of the transaction, "Glen Alden does not in fact acquire List, rather, List acquires Glen Alden."
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SECTION 13(d) AND Mosinee Paper

Last year, the Seventh Circuit handed down its decision in Mosinee Paper Corp. v. Rondeau,44 in which it considered the appropriate relief to be granted when a 5 percent shareholder fails to timely file Schedule 13D as required by the Williams Act.45 By May of 1971, the defendant had established a 5 percent position in the stock of Mosinee Paper Corporation. Within ten days after establishing such a position, he was required by the Williams Act to file Schedule 13D.46 However, he failed to file the appropriate schedule and continued acquiring Mosinee Paper stock. By August he had achieved an 8 percent position in the stock and thereafter filed the Schedule 13D.

That a violation of the Williams Act had occurred was conceded in all stages of the litigation. The issue before the district court was the appropriate relief to be granted. The plaintiff corporation sought an injunction that would either prohibit defendant from voting or pledging the stock or from acquiring additional shares or, alternatively, require defendant to divest himself of the stock. The district court granted summary judgment in favor of the defendant on basically two grounds: (a) no irreparable harm was suffered by the plaintiff corporation and (b) defendant's failure to file was not motivated by bad faith. The timing involved in the particular facts of the case lent plausibility to the lack of bad faith argument because until the prior December, filing had not been required until a 10 percent position had been obtained.47

The Seventh Circuit, in effect, held that the violation itself established harm but went on to find that the corporation had suffered actual harm. The harm would flow from the failure of the corporation to receive notice of a fact to which it had a right, namely, the existence of a 5 percent holder of its shares and the nature of his intentions, which resulted in a delay in its efforts to make an appropriate response to the new condition. It is also arguable that the shareholders of the corporation, both those who sell prior to the filing of the Schedule 13D and those who retain their shares, are harmed because relevant data, which may be material to them in making a decision to hold or retain their shares, is withheld despite a statutory mandate for disclosure.

Judge Pell dissented48 and once again his dissent found favor in the

44. 500 F.2d 1011 (7th Cir. 1974).
45. Act of July 29, 1968, Pub. L. No. 90-439, 82 Stat. 454. The Williams Act added sections (d) and (e) to section 13 of the Securities Exchange Act of 1934 and sections (d), (e), and (f), to section 14 of that Act.
48. 500 F.2d at 1017.
Supreme Court. The focus of his dissenting opinion was upon the necessity for irreparable harm, not just harm, in order to support the grant of the extraordinary relief of an injunction. The Supreme Court adopted Judge Pell's position and, in attempting to support its decision, reviewed the legislative concern with abuses in tender offers which prompted the Williams bill and found that the present facts gave rise to "none of the evils to which the Williams Act was directed." 49

The reasoning of the Supreme Court is questionable on several grounds. First of all, it is section 14(d) 50 which is aimed at tender offers; section 13(d) 51 is aimed at triggering notification solely upon the accumulation of the specified block of shares. In rule 10b-5 language, the Supreme Court "omitted to state a material fact" when it read the purpose of the Williams Act as being to insure that public shareholders who were confronted by the cash tender offer would have adequate information about the offering party. The purpose was also to require the dissemination of the required information when a holder reaches the specified position, whether or not he then intends a tender offer. In other words, the potential for control is the relevant fact requiring prompt disclosure. 52 This fact is buttressed by the existence of the exemptive power which Congress conferred to the SEC in section 13(d)(6)(D). Under that section the SEC was given the discretionary power to exempt from the Schedule 13(d) filing an acquisition of shares which is not entered into for the purpose of influencing the control of the issuer. 53 Until the SEC does act to exempt those transactions which are not

49. 422 U.S. 49, 59 (1975).
50. Section 14(d)(1) provides that it is illegal "to make a tender offer" for an equity security registered pursuant to section 12 of the Act if the tender-offeror would thereafter own more than 5 percent of such security unless the statement required by section 13(d) of the Act is filed. 15 U.S.C. § 78n(d)(1) (1970).

Any person who, after acquiring directly or indirectly the beneficial ownership of any equity security of a class which is registered pursuant to section 78l of this title . . . , is directly or indirectly the beneficial owner of more than 5 centum of such class shall, within ten days after such acquisition send to the issuer of the security at its principle 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 . . . .


The failure to provide adequate disclosure to investors in connection with a cash takeover bid or other acquisitions which may cause a shift in control is in sharp contrast to the regulatory requirements applicable where one company offers to exchange its shares for those of another, or where a contest for control takes the form of a proxy fight.

The purpose of section 13(d) is to require disclosure of information by persons who have acquired a substantial interest, or increased their interest in the equity securities of a company by a substantial amount, within a relatively short period of time.
for the purpose of influencing the control of the issuer, they are in fact covered by the statute.

Moreover, it is doubtful that the acquisition of the stock in question by the defendant was not made with a view toward an eventual tender offer. When the defendant filed his Schedule 13D in August, the statement did recite that consideration was currently being given to making a public cash tender offer. The trial court and Judge Pell apparently accepted the defendant’s contention that consideration of a cash tender offer did not arise until August and that prior to that time such an action had not been considered. This certainly places great faith upon the uncorroborated testimony by an interested witness of his subjective intent or lack thereof.

Finally, the Supreme Court intimated somewhat ambiguously in a footnote that injunctive relief, such as prohibiting the voting of shares, is only appropriate pending compliance with the reporting requirements. If this is true—and it is inconceivable that the Supreme Court had this in mind—there would be no reason to file a Schedule 13D until such time as injunctive relief is sought; once a failure to file is challenged, one need only file to forestall any relief. In this writer’s opinion, it was to preclude such dilatory tactics that the Seventh Circuit took a hard line and found that the existence of a violation itself supported injunctive relief. Under the Seventh Circuit’s approach, failure to file would carry with it serious consequences. Under the Supreme Court’s approach, failure to file is a desirable ploy to hide from both the management and the public the existence of the substantial position in the stock of the corporation as long as possible. Once it is discovered and legal action threatened, the failure to file can simply be cured.

It certainly appears that the Seventh Circuit’s opinion is the more enlightened one. Unfortunately, after the Supreme Court’s decision, it is not the law. As pointed out previously, however, the element of bad faith was treated as missing in the present case because of the recent change in the percentage which triggered reporting requirements from 10 percent down to 5 percent. At the time the action was filed, the defendant only held 8 percent. In the future, it is unlikely that either investors or raiders, as the case may be, achieving a more than 5 percent position in the corporation’s stock, will be able to allege and establish good faith in their failure to file. Consequently, the decision of the Supreme Court may be simply “much ado about nothing.”

In any event, it would appear that there is still the possibility that the SEC could bring an action for injunctive relief in a section 13(d) violation of the type litigated in Mosinee. The private plaintiff, as was pointed out in

54. 422 U.S. at 59 n.9, where the Court indicated that it was not called upon to decide whether an injunction could be obtained against exercising voting rights “pending compliance with the reporting requirements.”
Judge Pell's dissent and the majority opinion of the Supreme Court has two or possibly three hurdles: He (or it) must establish that a private cause of action exists, that he has standing to bring suit, and that the relief sought is appropriate. On the other hand, it is clear that the SEC has authority to bring injunctive actions for violations of the Act. It is also well established that the SEC, in connection with its injunctive action, is entitled to ancillary relief. It does not seem at all unreasonable that a defendant who violates the Act by failing to file after achieving a 5 percent position in the shares, and who continues to acquire additional shares, should be enjoined from voting the additional shares for some designated period of time. This would neutralize the effect of the defendant's violation of the statute. It may be that the five year disenfranchisement imposed by the Seventh Circuit was so long as to be punitive in nature. On the other hand, disenfranchisement for a year or two would appear to be a reasonable means for effectuating the policy of the state.

When a Note is a Security

Over the past few years, there has been considerable administrative and judicial activity involved with the determination of what constitutes a security. Tax shelters, such as investment condominiums, orange groves and cattle feeding and breeding operations have been determined to involve securities, at least under certain circumstances, as have also franchises, pyramid sales arrangements and the sale of Scotch whiskey

55. 500 F.2d at 1017.
56. 422 U.S. at 61.
57. Section 21e of the Securities Exchange Act of 1934, 15 U.S.C. § 78u(e) (1970), provides as follows:
Whenever it shall appear to the Commission that any person is engaged or about to engage in any acts or practices which constitute or will constitute a violation of the provisions of this chapter, or of any rule or regulation thereunder, it may in its discretion bring an action in the proper district court . . . to enjoin such act or practices, and upon a proper showing a permanent or temporary injunction or restraining order shall be granted without bond.
58. In SEC v. Texas Gulf Sulphur Co., 446 F.2d 1301, 1307 (2d Cir. 1971), the court stated:
However, despite some legislative history purportedly to the contrary, we do not read § 21(e) as restricting the remedies which the SEC can pursue to injunctive relief . . . Moreover, in other contexts the Supreme Court has upheld the power of the Government without specific statutory authority to seek restitution, and has upheld the lower courts in granting restitution, as an ancillary remedy in the exercise of the courts' general equity powers to afford complete relief.
warehouse receipts. The question has even been raised with respect to the sale of gold or silver bullion.

As is evident from the foregoing discussion, the direction of this activity has been, generally speaking, in the direction of expanding the notion of what constitutes a security. Until the last year or two, this trend had also held true when the question for consideration was whether or not a note constituted a security. Probably the most publicized case in this area developed out of the 1970 Penn Central bankruptcy when litigation ensued as to whether the Penn Central's commercial paper, though within the letter of the exception for commercial paper in the definition of a security under the 1934 Act, was nevertheless subject to the anti-fraud provisions of that act. The district court's opinion in the Penn Central case followed the four-pronged test adopted by Judge Sprecher in Sanders v. John Nuveen & Co.

Section 3(a)(10) of the 1934 Act defines security to mean "any note . . . but shall not include . . . any note . . . which has a maturity at the time of issuance of not exceeding nine months." Judge Sprecher's opinion in Sanders disregarded not only form for substance but also (quite properly) a literal reading of the statute. Implicitly relying upon the condition in the introduction to the definitions set forth in section 3(a) of the 1934 Act that such definitions shall apply "unless the context otherwise requires," he looked to the following four criteria which ought to be met if the instruments in question are "true" short term paper excluded from the definition of security under the 1934 Act:

[The instrument must be] (1) prime quality negotiable commercial paper (2) of a type not ordinarily purchased by the general public, that is, (3) paper issued to facilitate well recognized types of current operational business requirements and (4) of a type eligible for discounting by Federal Reserve banks.

67. 463 F.2d at 1079. These criteria were extracted from a 1961 release of the Securities Exchange Commission interpreting the 1933 Act's exemption of short-term commercial paper. 17 C.F.R. § 231.4412 (1975).
The commercial paper involved in Sanders was issued by a company at a time when it was insolvent. Furthermore, it was sold to forty-two purchasers in an aggregate face amount in excess of 1.5 million dollars. After applying the aforementioned standards to these facts, the court held that the notes failed to meet any of the above four standards and accordingly were securities subject to the anti-fraud provisions of the 1934 Act.

Judge Sprecher was undoubtedly correct in his assumption that Congress did not intend to exempt notes such as those involved in Sanders from the definition of a security. At the time the securities laws were enacted, commercial paper was primarily issued by industrial companies to facilitate seasonal financing and a major portion of it ended up in the portfolios of banks. Today, a substantial amount of commercial paper is issued by non-industrial concerns such as finance companies (as was the case in Sanders) and, instead of being issued purely for seasonal needs, in which case the paper is liquidated at the end of its term through the proceeds from the sale of inventory, it is rolled over as in the case of Penn Central. In this latter situation, supposedly short term paper becomes, in effect, a substitute for long-term financing.\(^7\) Thus, the context today is a substantially different one from that which existed in 1934 when the statutory provisions were enacted.

A year later, the Second Circuit, in Zeller v. Bogue Electric Manufacturing Corp.,\(^2\) agreed with the Seventh Circuit's decision in Sanders that "the mere fact that a note has a maturity of less than nine months does not take the case out of [rule 10b-5]\(^3\) and held that a demand note issued by a parent to its subsidiary was a security subject to the 1934 Act. The court focused upon the fact that the noteholder (the subsidiary) was occupying the position of an investor. Sanders was followed most recently in Zabriskie v. Lewis,\(^4\) where a woman who sought to invest in real estate was induced to lend her money to a "genius" to invest in a corporation which was going to be "one of the greatest stock developments" that ever existed. She received two 60-day notes. The court adopted the commercial-investment distinction and found that the notes were securities within the meaning of rule 10b-5. Thus, it is clear that today the character of the instrument cannot be determined merely by looking at the term appearing on the face of the instrument.

\(^{72}\) 476 F.2d 795 (2d Cir. 1973).
\(^{73}\) Id. at 800.
\(^{74}\) 507 F.2d 546 (10th Cir. 1974). The foregoing cases, holding that short-term paper may nonetheless be a security, and the cases dealing with the converse (discussed in text beginning at note 75 infra) are discussed in a two part series of articles, Lipton and Katz, "Notes" Are (Are Not?) Always Securities—A Review, 29 Bus. Law. 861 (1974); Lipton and Katz, "Notes" Are Not Always Securities, 30 Bus. Law. 763 (1965) [hereinafter cited as Lipton and Katz].
In the past year, the Seventh Circuit, in *C.N.S. Enterprises, Inc. v. G. & G. Enterprises, Inc.*, was confronted with the converse of the *Sanders* case: the notes in question had a maturity date in excess of nine months and therefore were outside the exception contained within the definition of security in section 3(a)(9) of the 1934 Act. Presumably, therefore, the notes were within the general definition of a security including "any note". However, it was argued that, notwithstanding the fact that the notes in question were encompassed by a literal reading of the statute, the context was such that they should be considered outside the intended scope of the statute. Judge Sprecher again wrote the opinion of the court but this time, rather than embracing an expansive approach, he delimited the scope of the securities laws and held that the notes in question were not securities within the purpose of the 1934 Act.

The fact situation under consideration by the court can be summarized briefly as follows. Plaintiffs purchased the "fixtures, merchandise, business and good will" of an existing business from defendants. In connection with the transaction, they assumed a chattel mortgage on the fixtures, giving their note to the bank, and borrowed an additional sum from the bank evidenced by a note secured by a junior chattel mortgage.

In distinguishing *Sanders*, Judge Sprecher characterized it as involving an "investment" instrument, whereas the notes in question in the present case involved "commercial" instruments. The court recognized that it is one thing to state a "commercial-investment" dichotomy but a much more complex task to apply it to varying sets of facts. It would appear that according to Judge Sprecher, the key to unraveling the dilemma imposed by varying fact situations was to determine from where the "impetus" for the transaction came. After pointing out that every lender is in effect an investor and every investor in a non-equity security is in effect a lender, he went on to state:

On the other hand, the polarized extremes are conceptually identifiable: buying shares in a common stock of a publicly held corporation, where the impetus for the transactions comes from the person with the money, is an investment; borrowing money from a bank to finance the purchase of an automobile, where the impetus for the transaction comes from the person who needs the money, is a loan. In between is a gray area which, in the absence of further congressional indication of intent or Supreme Court construction, has been and must be in the future subjected to case-by-case treatment.

While the opinion analyzed the decisions in other circuits which have intervened between *Sanders* and *C.N.S. Enterprises*, and also enumerated

75. 508 F.2d 1354 (7th Cir. 1975).
76. Id. at 1359.
the tests suggested in the literature, the conclusion that the notes in question were not securities appeared to be based upon the fact that the bank was in no way a joint venturer with the plaintiffs and the fact that the impetus for the transaction came from the plaintiffs and not from the bank.

With all due respect to Judge Sprecher, who has exhibited both imagination and understanding in his many opinions dealing with the securities laws over the past few years, the introduction of the concept of "impetus" is more a distraction than an aid in resolving the very complex question concerning the circumstances under which a note is a security and those under which it is not.

The impetus approach, in this author's opinion, affords no real assistance. Consider Judge Sprecher's example at the end of the spectrum where he suggests that a security is obviously present, namely, the sale of common shares. He suggests in this circumstance that the impetus comes from the person with the money and that therefore this reflects the fact that a security is involved. He would contrast this with a loan transaction in which an individual goes to the bank—in which case the impetus comes from the person who needs the money.

On closer examination, however, the impetus in both cases comes from the person who needs the money, not the person with the money. It is true that, with respect to the sale of stock in the trading market, the impetus could be said to come from the person with the money. But to avoid comparing apples and oranges (issuance of a note vis-a-vis trading in stock), the relevant market to look at with respect to stock is the distribution market in connection with the issuance of stock by the issuer. In that market, the very existence of the investment banking community, and the premium paid to underwriters for the sale of stock in the initial distribution thereof, reflects the fact that the impetus comes from the issuer of the security, who utilizes the services of underwriters, and not from the person with the money who is buying the stock. The whole scheme of the 1933 Act is to protect the potential purchaser of stock from unscrupulous sales activity in connection with the issuance (distribution) of the security.

In this writer's opinion, it is possible to be no more precise than to take the investment-commercial dichotomy and seek to flesh it out with various factual categories which may point in one direction or the other. While many factors have been suggested as being relevant, there are basically three critical factors: (a) the character and sophistication of the buyer or holder of the instrument; (b) the purposes for which the issuer of the instrument creates the instrument; and (c) the term of the instrument. Each of these factors will now be examined in more detail.

With respect to the character of the holder, it is fitting to first look to the example of a bank as an acquirer of the instrument. Banks have both a commercial side and an investment side and in many instances the nature of the transaction could be inferred by the office of the bank in which it was consummated. On the other hand, when an insurance company purchases an instrument, it could normally be assumed that the transaction is an investment because insurance companies are not in the business of extending credit but rather in investing their funds so as to be able to meet obligations to their policy holders. Similarly, an individual, such as the defrauded woman in Zabriskie,\(^7\) who was originally interested in the opportunity to invest in real estate and was induced to lend money to a promoter and its corporation, is generally not in the business of extending credit but rather in making investments.

Looking at the purpose for which the issuer of the instrument creates it, an individual who seeks funds and issues his note for consumer goods is involved in a credit and not an investment transaction. Thus, the nature of the goods tells something about the nature of the transaction. Even if one is dealing with business goods, if the purpose of the transaction is to provide the funds to acquire specific property—particularly if the issuer of the instrument creates a security interest in the property to be acquired to secure the instrument—one is most likely dealing with a commercial and not an investment situation. If, however, the purpose of the transaction is to provide risk capital or working capital for the issuer of the instrument, then the transaction most likely is an investment and not a commercial transaction. This does not mean that it will always be easy to determine whether or not the purpose of the transaction was to provide working capital rather than to acquire specific assets.

With respect to the term of the transaction, the longer the term of the instrument the more likely it is an investment instrument and the shorter the term of the instrument the more likely it is a commercial instrument. For example, common stock is an instrument with a term extending into perpetuity. While a particular holder of the instrument may hold it for only a short time, the instrument itself, reflecting the permanent capital in an entity of perpetual duration, is obviously a long-term instrument. At the other end of the spectrum, "pure" commercial paper, issued for thirty to ninety days to carry seasonal inventories, is obviously a credit transaction. Most notes purchased by an insurance company will have a term of five years or more and thus will represent an investment transaction rather than a commercial transaction. Somewhere in between the insurance company transaction and the pure commercial paper situation would be the three-year car loan, but there the question of whether a security is involved could be resolved by resort to the nature of the issuer and the purpose of the transaction.

78. 507 F.2d 546 (10th Cir. 1974). See also note 74 supra.
With respect to the term of the instrument, there are obviously many transactions that do not fit within the general pattern of a long term indicating the likelihood that a security is involved. For example, in the financing of real estate, a commercial transaction is usually involved and fifteen to twenty-five year terms are quite common. At the other end of the spectrum, the defrauded woman in Zabriskie received a note which was by its terms to be outstanding for only two months. Yet it was held to constitute a security. But again, the other two factors, the nature of the holder and the purpose of the transaction, pointed in the direction of a security. Thus, while particular fact patterns may not be free from ambiguity, looking to the nature of the purchaser, the purpose of the issuer and the term of the instrument will at least provide some keys which should point in the proper direction.

There is another approach which merits consideration, however, when a note is given in connection with the purchase of business assets, as was the case in C.N.S. Enterprises. It would appear that the focus, rather than being upon whether the note given by the buyer in acquiring the business was a security, might better be upon whether what the seller is selling, irrespective of form, is a security. Consider the various permutations which may be involved when one corporation (referred to as “Acquirer”) buys the business of another (referred to as “Target”).

It is clear that if Acquirer issues its stock to purchase the stock of Target from the latter's shareholders, the securities laws apply since there is obviously an exchange (sale and purchase) of two securities. It is also clear that if Acquirer issues its notes for the stock of Target, the securities laws apply since there is clearly involved the sale of a security (Target’s stock) by Target's shareholders. Finally, if Acquirer pays cash for the stock of Target, the securities laws are applicable for the reason stated immediately above. Assuming that there are misstatements by the seller as to the condition of the business being sold, which underlies the stock of Target, the foregoing are classical situations for the application of the securities laws.

Consider another situation. Instead of the stock of Target being sold, Target sells its assets subject to liabilities (referred to as “net assets”), receives the consideration from Acquirer and thereupon dissolves, distributing its assets to its shareholders. Once again, if Acquirer issues its shares in return for the net assets of Target, there is no question but that there is a transaction involving the purchase or sale of a security, namely, the issuance of Acquirer's shares, and rule 10b-5, for example, would apply. On the other hand, if Acquirer were to issue its notes in exchange for the net assets of Target, the teaching of C.N.S. Enterprises is that there is no security involved and consequently no basis for the application of the securities laws. Similarly, if Acquirer paid cash for the net assets of Target, it is suspected that there are few commentators, and no cases, which would hold that there
is yet a security involved in the transaction such that the security laws can apply. The closest judicial recognition of this possibility appears to be Judge Sprecher's earlier opinion in *Sanders v. John Nuveen & Company, Inc.*, 79 in which he indicated that even if the commercial paper which Nuveen was selling was not itself a security, the placing of capital in Nuveen's hands for investment created an investment contract.80

It would appear that the thread common to all six situations is that the seller has been conducting a business in which the buyer seeks to invest. The investment character of the transaction is clear when what the buyer purchases is stock, irrespective of the consideration issued by the buyer. However, when it purchases net assets, it is just as clearly making an investment as when it purchases stock. Conceivably, the form in which the business is sold may turn upon the number of shareholders of Target since a large number of shareholders may make the transaction too cumbersome if effected in the form of a stock acquisition. Surely such a factor should not control indirectly the determination of whether a security is involved in the transaction.

Should form control substance? The Supreme Court has repeatedly counseled to the contrary, particularly where the issue is whether a security is involved.81 It appears to this writer that considering the purpose of the securities laws, namely to protect an investor, form should not be allowed to hide the true substance of the transaction. Thus, the contract whereby a purchaser acquired net assets (or "hard" assets coupled with goodwill),82 and not just "dead" assets, may properly be characterized as an investment contract and thus a security, thereby subjecting the seller to liability under rule 10b-5 if the other requisite elements of securities fraud are present.

In taking the investment contract approach to resolution of the *C.N.S. Enterprises* situation, one conceptual difficulty arises. Most of the litigation involving the question of whether an investment contract exists has focused upon the so-called active-passive dichotomy. For example, in the sale of orange groves or oil leases, the buyer was a passive participant in an enterprise operated by the active participant.83 Where no such active-

79. See text at note 67 supra.
80. 463 F.2d at 1080.
82. To get at the essence of the situation, the most rational distinction to be made in determining whether the sale of assets of a business constitutes the sale of a security is whether the value of the assets is established, at least in part, by looking through the capitalized earnings value of the business. If earnings are a factor in determining a price of the assets, then obviously something more than "mere" assets are being sold and the situation is an "investment" situation rather than a purchase of tangible property.
passive dichotomy has been found, the existence of a security has usually been decided in the negative.\textsuperscript{84}

However, it can be argued that most of the opinions denying the existence of a security can be reconciled with a holding that \textit{C.N.S. Enterprises} did involve an investment contract because, in effect, those opinions merely held that the plaintiff was not buying into a business but rather was purchasing tangible assets or a service or a license. That the purchaser in \textit{C.N.S. Enterprises} was buying into a business and not merely acquiring some assets cannot be gainsaid.\textsuperscript{85} Stock in a closely held corporation is no less a security because it is held by only one shareholder and the sale of such stock to only one purchaser who will control the operation of the business after the purchase does not make it any less the sale of a security to him. If an enterprise, the nature of which is the subject of investment, exists, then the active-passive dichotomy is irrelevant since the underlying question has already been answered in the affirmative.

**Proxy Solicitation**

\textit{Northway, Inc. v. TSC Industries, Inc.}\textsuperscript{86} involved a not atypical corporate acquisition challenged as fraudulent for misleading disclosure under the proxy rules. The transaction involved a stock-for-asset transaction\textsuperscript{87} in which the acquiring corporation (National) first purchased what was probably a controlling block of shares\textsuperscript{88} for cash, obtained working control of the board of directors, and then, in effect, merged the two corporations, arguably at a disadvantageous price to the minority shareholders of the target corporation (TSC). Northway, a minority shareholder, alleged that the proxy solicitation necessary to authorize the transactions violated rule 14a-9 of the 1934 Act.

The court had under consideration three legal issues and the factual environment attendant to them: (a) The obligation to disclose a change in control of the issuer within the prior year, if such had occurred; (b) the

\textsuperscript{84} See, e.g., Mr. Steak, Inc. v. River City Steak, Inc., 460 F.2d 666 (10th Cir. 1972).

\textsuperscript{85} 508 F.2d at 1355. The opinion recites that “good will” was purchased and the plaintiffs alleged that an inducement in acquiring the business were the monthly sales figures given to them by defendants.

\textsuperscript{86} 512 F.2d 324 (7th Cir. 1975).

\textsuperscript{87} The opinion erroneously characterizes the transaction as a “stock-for-stock purchase”. In a stock-for-asset transaction, the seller of the assets, after receiving the stock from the purchaser, dissolves and distributes the purchaser’s stock to the seller’s shareholders. Thus the seller’s shareholders end up with stock of the purchaser but in a two-step transaction. The basic transaction is stock for assets.

\textsuperscript{88} 512 F.2d at 327-28. Approximately one-third of the stock was acquired from the Schmidt family, which was probably sufficient for control. In point of fact, after the acquisition of this block of shares, four nominees of the acquiring corporation were elected to the ten-man board of directors. In addition, officers of the acquiring corporation became the chief executive officers of TSC.
The materiality-causation syndrome was resolved by the Supreme Court in *Mills v. Electric Autolite Co.*, when Mr. Justice Harlan stated:

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 [r]ule 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 [section] 14(a).

There is no need to supplement this requirement, as did the Court of Appeals, with a requirement of proof of whether the defect actually had a decisive effect on the voting. Where there has been a finding of materiality, a shareholder has made a sufficient showing of a casual 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. This objective test will avoid the impracticalities of determining how many votes were affected, and, by resolving doubts in favor of those the statute is designed to protect, will effectuate the congressional policy of ensuring that the shareholders are able to make an informed choice when they are consulted on corporate transactions.

While Mr. Justice Harlan’s opinion now makes it clear that once materiality is established, specific proof of causation is unnecessary (provided that the

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89. With respect to the first issue, the court acknowledged that Schedule 14A, Item 5 requires a proxy statement to disclose a change in the control of the issuer occurring since the beginning of the last fiscal year. 17 C.F.R. § 240.14a-101, item 5(e) (1975). However, the court was of the opinion that the issue of control was a factual issue which could not be determined on a motion for summary judgment. 512 F.2d at 329. With respect to the third issue, the court did hold that there was a duty to investigate the transferee whenever a controlling shareholder transfers a controlling interest but held that the “duty in every case is tied to the nature of the peculiar circumstances which exist at the time of such a transfer.” 512 F.2d at 342. The court determined that the investigation made by the controlling persons prior to the sale of their shares was adequate.


91. *Id.* at 384-85 (emphasis added).
proxy statement itself was an essential link in the transaction), his language as to what is necessary to establish materiality has engendered conflicting points of view.\textsuperscript{92} Materiality is determined by reference to the reaction of a reasonable shareholder to the information in question. But the split as to the proper test comes in determining whether the information \textit{possibly} would have influenced the reasonable shareholder or \textit{probably} would have influenced the reasonable shareholder.

Judge Friendly, in \textit{Gerstle v. Gamble-Skogmo, Inc.},\textsuperscript{93} recognized the dilemma created by the juxtaposition of the phrases "might have" and "significant propensity" in Judge Harlan's opinion. He opined that the "might have been" standard set too low a threshold and held that "a standard tending toward probability rather than toward mere possibility is more appropriate."\textsuperscript{94}

In \textit{Northway}, Judge Swygert took the contrary view that a "possibility" standard would further the prophylactic effect of the disclosure provisions which were enacted to establish a full disclosure ethic. The significant difference, according to Judge Swygert, is that the possibility test "will not reach 'trivial' and 'unrelated' fact; neither will it fail to reach facts which may be relevant for some, but not for others."\textsuperscript{95}

While there is much appeal for this approach to "materiality", nevertheless there would appear to be an internal inconsistency in this approach since causation flows from materiality and materiality flows from that which some (but not necessarily all or even a significant number) of the shareholders may find important. Unless a substantial portion of the shareholders would find the omitted or misstated information material, the transaction would be approved notwithstanding the omission or misstatement. It can hardly be said, therefore, that the omission or misstatement could be a causative factor in the approval of the transaction.

The effect of establishing this standard in terms of possibility rather than probability is to change, at least in many instances, the question of materiality from one of fact to one of law. Indeed, in \textit{Northway} Judge Swygert considered the five allegedly fraudulent omissions or misstatements and held that, as a matter of law, four violated rule 14a-9.\textsuperscript{96} Two of the defects dealt with the degree of control exercised by National over TSC at the time of the proxy solicitation and two related to matters going to the value of the stock of National which was to be issued in the transaction. As to these, Judge Swygert held the defects material as a matter of law. The final alleged defect dealt with the mechanics of board action at the meeting.

\textsuperscript{92} See text at note 93 \textit{infra}.
\textsuperscript{93} 478 F.2d 1281 (2d Cir. 1973).
\textsuperscript{94} \textit{Id.} at 1302.
\textsuperscript{95} 512 F.2d at 324.
\textsuperscript{96} \textit{Id.} at 333-36.
in which the TSC board of directors purportedly approved the transaction. Judge Swygert held that reasonable men could differ as to the significance of this disclosure and that the materiality of the omission accordingly could not be properly determined on a motion for summary judgment.

**SHARES IN TRUST—THE NUMBER OF HOLDERS**

*Tankersley v. Albright*[^97] involved the litigation over the reorganization of the [Chicago] Tribune Company. The part of the litigation of interest from a securities law standpoint involved the question of whether the company had violated the securities laws by failing to register its stock with the SEC and generally comply with those obligations which a "reporting" company must fulfill under the 1934 Securities and Exchange Act[^98]. This in turn raised the question of whether the company had (i) 500 or more stock holders and (ii) $1 million in assets, as it is these two criteria which trigger the 1934 Act registration requirement[^99]. The question of whether the Tribune Company had $1 million or more in assets obviously was not an issue; the question of whether it had 500 or more shareholders was. The litigation involved two trusts. One, designated as the "McCormack-Patterson" trust, was a voting trust having as its corpus 53 percent of the outstanding common stock of the Tribune Company. The other, designated as the employees trust, contained units of beneficial interest in the McCormack-Patterson trust.

Rule 12g5-1[^100], promulgated by the SEC pursuant to section 12 of the 1934 Act, defines the concept of securities "held of record" for purposes of determining the need to register stock under section 12 and in subparagraph (a) (2) treats shares held of record by a trust as held by one person. However, sub-paragraph (b) (1) provides that securities held subject to a voting trust shall be deemed to be held of record by the record holders of the voting trust certificates.

It was apparently conceded in the litigation that the McCormack-Patterson trust was a voting trust and that therefore both the beneficiaries of the trust and the shareholders of record holding the other 47 percent of the stock would be counted in determining whether or not there were 500 shareholders of record. But since there was a two-tiered trust relationship, in order to determine the number of beneficiaries under the McCormack-Patterson trust it was necessary to resolve whether the employees trust

[^97]: 514 F.2d 956 (7th Cir. 1975).
[^100]: 17 C.F.R. § 240.12g5-1 (1975).
should be considered a single holder or, alternatively, a voting trust such that the beneficiaries of the employees trust would be deemed to be holders of beneficial interest [securities] in the McCormack-Patterson trust and then further imputed to be holders of record in the Tribune Company for purposes of determining the existence, or lack thereof, of the requisite 500 holders. The situation is illustrated in Figure 2.

The court held that the employees trust was a "formal" trust and not a "voting" trust and that therefore it constituted one record holder. In so holding, the court listed a series of facts which it thought indicated a formal or ordinary trust rather than a voting trust or special agency.\footnote{101} Upon analysis, however, it is clear that the court failed to examine the essence of the difference between a voting trust and an ordinary trust.

In a voting trust, the holder of all the incidents of ownership in a security transfers the security to a trustee for the purpose of separating the voting power of the security from the other incidents of ownership, with the settlor retaining the other incidents of ownership. By statute, such a trust is limited to ten years.\footnote{102} The essence of the transaction is that the settlor is

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\includegraphics[width=\textwidth]{figure2.png}
\caption{SAME PERSONS}
\end{figure}

\textbf{FIGURE 2}

The court stated:
Under the terms of the trust, the units so conveyed are to be treated in all respects as a single undivided interest in the McCormick-Patterson Trust and the original employee beneficiaries are to lose all right to call for a partition or division of the trust corpus. Provisions in the employees' trust also prohibit any employee beneficiary from transferring or assigning his or her interest in the employees' trust without first successively offering this interest to Robert R. McCormick, Joseph M. Patterson, the president of the board of directors of the Tribune Company, the trustees of the employees' trust, and finally, all of the employee beneficiaries. The trustees of the employees' trust are given significant power and authority in dealing with the trust corpus. They have express power to take any action or give any consent permitted to be taken or given by a beneficiary of the McCormick-Patterson Trust, including actions aimed at extending the life of the McCormick-Patterson Trust. Finally, the employees' trust is to last for the lives of the original beneficiaries plus twenty-one years unless earlier terminated by the unanimous vote of all beneficiaries and Robert R. McCormick if alive, or Joseph M. Patterson, if alive. 514 F.2d at 968-69.

\footnote{101}{The court stated: Under the terms of the trust, the units so conveyed are to be treated in all respects as a single undivided interest in the McCormick-Patterson Trust and the original employee beneficiaries are to lose all right to call for a partition or division of the trust corpus. Provisions in the employees' trust also prohibit any employee beneficiary from transferring or assigning his or her interest in the employees' trust without first successively offering this interest to Robert R. McCormick, Joseph M. Patterson, the president of the board of directors of the Tribune Company, the trustees of the employees' trust, and finally, all of the employee beneficiaries. The trustees of the employees' trust are given significant power and authority in dealing with the trust corpus. They have express power to take any action or give any consent permitted to be taken or given by a beneficiary of the McCormick-Patterson Trust, including actions aimed at extending the life of the McCormick-Patterson Trust. Finally, the employees' trust is to last for the lives of the original beneficiaries plus twenty-one years unless earlier terminated by the unanimous vote of all beneficiaries and Robert R. McCormick if alive, or Joseph M. Patterson, if alive. 514 F.2d at 968-69.}

\footnote{102}{See, e.g., ILL. REV. STAT. ch. 32, § 157.30a (1973), which provides as follows: Any number of shareholders of a corporation may create a voting trust for the purpose of conferring upon a trustee or trustees the right to vote or otherwise represent their shares, for a period of not to exceed ten years, by entering into a written voting trust agreement specifying the terms and conditions of the vot-}
the beneficiary and has separated legal and equitable title for the sole purpose of giving legal title to the trustee only for voting purposes. In other words, the essence of the transaction is that the settlor intends to lose one, and only one, incident of ownership, namely, the right to vote. As an aftermath of the transaction, the settlor qua beneficiary may sell or assign his beneficial interest, which is normally explicitly made assignable, and thereby be divorced from all interest in the security which formed the corpus of the trust.

On the other hand, the essence of a formal trust is the creation of a new estate in a third party, the beneficiary. In other words, the essence of the transaction is the creation of an interest in a third party with respect to the security; the fact that the trustee rather than the beneficiary votes the shares is only incidental to the transaction. In point of fact, the settlor may be the trustee of the trust, in which case it is obvious that his intention was to retain voting power while transferring all the other incidents of ownership to the beneficiaries of the trust. There are also situations in which the settlor is a beneficiary of the trust but even in that case, while the trustee may be a beneficiary of the trust and retain an interest in the subject matter of the trust—for example a life estate—there invariably is the creation of an estate in a third party.

In summary then, the creation of the voting trust involves the settlor of the trust stripping himself of the right to vote but retaining the other incidents of ownership, whereas the creation of an ordinary trust has as its essential purpose the creation of an interest in a third party with the right to vote incidently transferred to the trustee as record holder.

In Albright, 38 executives of the Tribune Company who were holders of beneficial interest in the McCormack-Patterson trust stripped themselves of all interest in the certificates of beneficial interest and transferred them in trust so as to create a beneficial interest in the employees of the company. Thus, the court reached the right result—that the employees trust was truely an ordinary or formal trust and not a voting trust—but upon somewhat imprecise reasoning.

Another way of looking at the situation would be as follows. There are basically three interests in a corporation represented by the stock thereof: the right to vote, the right to receive dividends (profits) and the interest in
the assets of the corporation upon liquidation (property). The essence of the voting trust is to transfer one of these interests, the voting power, to a trustee; the essence of the ordinary trust is to transfer the other two interests, the right to dividends and the right to receive assets upon liquidation, to a third party designated as the beneficiary. In the latter instance, the impetus of the transfer of legal title to the trustee is not so much to give the right to vote to the trustee as to provide for the management of the trust corpus by the trustee for the benefit of the beneficiary.

RULE 10b-5

Scienter, Materiality, Reliance and Exclusivity

Three decisions of the Seventh Circuit during the past year dealt with the issues of scienter, materiality, and reliance as requisite elements in successfully stating and proving a cause of action under rule 10b-5. In each of these cases, the Seventh Circuit manifested an extremely liberal position and, in Burns v. Paddock, exhibited what appeared to be undue tolerance for ineptly drawn pleadings seeking to state a cause of action under rule 10b-5. In another case, the court held that the fact that a set of facts may give rise to a cause of action under one of the specific liability provisions of the securities laws does not preclude liability under rule 10b-5 as well.

In Tomera v. Gal the court dealt with the question of scienter, or the state of mind necessary to charge a person with liability under the securities laws. Various positions obtain among the circuits and about all that can presently be said with certainty is that excluded from the continuum at either extreme are the possibilities of strict liability on the one hand and specific intent to defraud on the other. Thus, the continuum for culpability would seem to extend from negligent to knowingly but without specific intent. In this writer's opinion, the proper test for the necessary state of mind to establish culpability should be the "knew or should have known" test.

Previous decisions have indicated that the Seventh Circuit is one of the more liberal circuits on the issue of scienter and that, on the culpability continuum, its position is much closer to strict liability than specific intent to

104. See, e.g., the definition of shares in ILL. REV. STAT. ch. 32, § 157.2-6 (1973). Before it was amended in 1961, the section defined share as "the units into which the shareholders' right to participate in the control of the corporation, in its surplus or profits, or in the distribution of its assets are divided." Similarly, the Illinois Partnership Act provides that the property rights of a partner are his rights in the partnership property, his interest in the partnership [profits] and his right to participate in the management. ILL. REV. STAT. ch. 106½, § 24 (1973).
105. 503 F.2d 18 (7th Cir. 1974).
107. 511 F.2d 504 (7th Cir. 1975).
deceive. As a matter of fact, the Seventh Circuit stated three years ago, in choosing the appropriate statute of limitations, that rule 10b-5 does not contain the defense that one "did not know and in the exercise of reasonable care could not have known" of the misrepresentation which is alleged to constitute fraud under the securities laws. In Tomera, Judge Sprecher quoted this language to support his statements that "[r]ule 10b-5 claimants need not plead nor prove scienter." The issue of scienter, however, has not yet received the extended, in-depth treatment necessary to establish a categorical position by the Seventh Circuit on the issue of scienter.

The question of materiality was raised in Hidell v. International Diversified Investments. The promoter of the corporation and one other investor had obtained cheap stock in the corporation (the investments were approximately 20 cents and 5 dollars per share, respectively) and then sought to sell an additional twenty thousand shares at $25 per share. Six 1000-share subscriptions were obtained on the condition that the remaining shares be sold. After several months had passed, however, it was clear that the corporation was not going to sell all twenty 1000-share subscriptions. The promoter of the corporation then sent a letter to the six subscribers on September 17, 1971 which stated that "we now believe that the immediate objective of I.D.I. can be achieved with equity capital of approximately $175,000 to $200,000" and that the $150,000 already provided by the six subscribers, plus the $40,000 invested by the promoter and the other investor, would permit I.D.I. to commence operations. The letter requested the subscribers to consent to the elimination of the 20,000-share condition.

On September 20, 1971 the promoter travelled to Philadelphia from Illinois and induced the plaintiffs to sign an amendment to the subscription agreement eliminating the condition. Once again he informed them that the company had $190,000 in capital. A few days later, on September 29, the promoter entered into a repurchase agreement on behalf of I.D.I. with another subscriber who would not consent to the amendment to the subscription agreement unless the corporation agreed to repurchase his shares at his option.

The plaintiffs argued that the failure to disclose the fact that one of the six investors would not consent to the waiver of the 20,000-share requirement without a repurchase agreement by the corporation was a material fact which should have been disclosed and, in the absence of disclosure, amounted to a fraud in connection with the purchase or sale of a security. The difficulty with the plaintiffs' position was that the repurchase agreement in

109. Id.
110. 511 F.2d at 508.
111. 520 F.2d 529 (7th Cir. 1975).
112. Id. at 533.
question was not executed until after they had consented to the amendment of the subscription agreement. The Seventh Circuit, however, in a per curiam opinion, focused on the fact that the other subscriber had requested concessions prior to the time the promoter contacted plaintiffs in Philadelphia and the fact that at the time of the September 20 conversation the promoter knew that the statement as to the $190,000 capitalization was not a completely truthful statement of the then-current status of the corporation's financing.

It is questionable whether the request of another subscriber for concessions was a material fact which ought to have been brought to the attention of the plaintiffs at the time of the negotiations. However, it would seem equally clear that when a concession was in fact given to another subscriber, this was an event of import to the other subscribers and one that ought to have been disclosed. The evil then was not the failure to disclose the non-material fact (the request for concession) at the time of the negotiations leading up to the amendment of the subscription agreement but rather the failure a few days later to disclose to the other investors that a concession had been made to one of the subscribers.

The problem with focusing upon the later time period is that there was no disclosure at all to the other investors at that point in time—so that there was no misdisclosure. The question then arises as to whether there was an affirmative obligation to disclose. Using a traditional contract approach, the transaction with plaintiffs had been "closed" on September 20 and there remained no further obligations to the plaintiffs arising out of that transaction. Moreover, even if disclosure of the special concession given to one of the subscribers was made at the later point, it may be argued that if the transaction was a closed one disclosure would have served no useful purpose.

Thus, the problem is not so much one of disclosure but one of basic fairness in dealing with all persons similarly situated by a person who, as promoter of the enterprise, stands in a fiduciary relationship to all subscribers. What the Seventh Circuit was in effect trying to accomplish by its holding was a policy comparable to that introduced into the area of tender offers by the 1968 amendments to the 1934 Securities Exchange Act, which provided that when any person improves the terms of a tender offer before its expiration by increasing the consideration offered to shareholders who have not as yet tendered their shares, the tender-offeror shall pay the increased consideration to each shareholder whose securities have already been tendered, taken up and paid for by the tender offeror prior to the increase in consideration.\footnote{113. 15 U.S.C. § 78n(d)(7) (1970).}

The dilemma to be faced by a court is whether such a policy, which is undoubtedly within the competence of the legislature to impose, can be judicially imposed through rule 10b-5 by holding, for example, that the
failure to treat all subscribers alike in *Hidell* operated as a fraud or deceit upon them. In other words, it seems these problems would be easier to resolve if rule 10b-5 could be recognized as encompassing substantive obligations of fairness and not merely procedural requisites for disclosure. This is, in effect, what the SEC is attempting to do in connection with its challenges of the recent phenomenon of "going private".

Another rule 10b-5 case which involved the question of what constitutes fraud under the securities laws and whether reliance had been properly pleaded was *Burns v. Paddock*. The bulk of the opinion dealt with the attempt by the court to reconstruct the pleadings to avoid dismissing the complaint. Since the opinion was bedeviled by the lack of specificity in the pleadings, the only clear insight that evolves from the opinion is the position that a promise made with no intention of keeping the same can constitute fraud under the securities laws. While some state courts might yet today question this proposition—and as a matter of fact the district court hearing the case dismissed the count on the basis that broken promises did not constitute securities fraud under rule 10b-5—Judge Pell quite properly opined that a promise made with deceptive intent violates securities laws.

The question of the exclusivity of particular securities laws confronted the court in *Schaefer v. First National Bank of Lincolnwood*. The defendants contended that their conduct involved a market manipulation scheme that was squarely within the prohibitions of section 9(a)(2) of the 1934 Act and that, in effect, this explicit liability provision was the exclusive remedy. If resort to rule 10b-5 were thereby foreclosed, plaintiffs would have been confronted with the shorter limitation period set forth in section 9(e). The court followed one of its earlier decisions and held that the "remedies provided by Section 10(b) as well as the other sections of the securities acts are cumulative and not mutually exclusive".

**Statute of Limitations**

In 1972, the Seventh Circuit held, in *Parrent v. Midwest Rug Mills*,

116. 503 F.2d 18 (7th Cir. 1974).
117. *Id.* at 23.
118. 509 F.2d 1287 (7th Cir. 1975).
120. 15 U.S.C. § 78i(e) (1970) provides as follows:
   No action shall be maintained to enforce any liability created under this section, unless brought within one year after the discovery of the facts constituting the violation and within three years after such violation.
Inc.,\textsuperscript{123} that the statute of limitations to be applied to actions brought under section 10(b) of the Securities and Exchange Act of 1934 and rule 10b-5 promulgated thereunder was to be that statute of the forum state which "best effectuates" the policy behind those provisions of the federal securities laws.\textsuperscript{124} The Parrent court found that the civil liability provisions of the Illinois Securities Law of 1953 resembled in scope and purpose section 10(b) of the 1934 Act and held that the controlling limitation period was the three-year term set forth in section 13 of the Illinois securities law,\textsuperscript{125} rather than the five-year term provided for in the general limitation statute applicable to common law fraud actions brought in Illinois.\textsuperscript{126} In looking to the state securities laws for the applicable limitation, the decision has failed to produce uniformity or reduce forum shopping since each state within the circuit has blue sky laws with varying limitation periods.\textsuperscript{127}

Two recent decisions by the Seventh Circuit refined the effect of the Parrent case. In Schaefer v. First National Bank of Lincolnwood,\textsuperscript{128} the plaintiffs alleged that the defendants had violated the federal securities laws by reason of varying degrees of involvement in a market manipulation scheme involving a certain security. The claim was based on events allegedly occurring between 1965 and 1967. These same events had, in 1967, given rise to an indictment and eventual criminal prosecution in the Southern District of New York.\textsuperscript{129}

The original complaint was filed in February of 1969. Shortly thereafter, the defendants moved to have the suit dismissed in its entirety on the grounds that it was barred by the statute of limitations. The district court denied the motion on the ground that the applicable limitation period for section 10(b) actions brought in the Northern District of Illinois was five years, applying the Illinois statute of limitations for bringing common law fraud actions.\textsuperscript{130} Subsequently, the criminal prosecution terminated in New York, resulting in the conviction of all the indicted conspirators. Discovery relative to those parties had been suspended pending termination of the criminal action. When discovery was completed, a second amended complaint was filed in the fall of 1972, naming the American Stock Exchange and several of its specialists as party defendants.\textsuperscript{131} All of the newly added parties and one of the parties named in the original complaint\textsuperscript{132} immediate-

\textsuperscript{123} 453 F.2d 123 (7th Cir. 1972).
\textsuperscript{124} Id. at 126-127.
\textsuperscript{125} ILL. REV. STAT. ch. 121 1/2, § 137.13(d) (1973).
\textsuperscript{126} ILL. REV. STAT. ch. 83, § 16 (1973).
\textsuperscript{127} See Horwich and Ruder, note 1 supra, at 404-05 nn. 260, 280.
\textsuperscript{128} 509 F.2d 1287 (7th Cir. 1975).
\textsuperscript{129} Id. at 1290-91.
\textsuperscript{130} The district court's opinion was prior to the decision in Parrent.
\textsuperscript{131} 509 F.2d at 1291.
\textsuperscript{132} The original defendant who moved for dismissal was Rodman & Renshaw. Id. at 1290.
ly moved for dismissal on the basis that the recently decided Parrent case clearly established that the plaintiffs' case was barred by the statute of limitations set forth in the Illinois securities law and the district court dismissed all counts against these defendants.

The main thrust of that part of the opinion dealing with the statute of limitations issue dealt with the impact of the three year limit upon Rodman & Renshaw, a brokerage house named in the original complaint. One of its employees had participated in the planning of the scheme but left its employ in late 1965 before the scheme ran its course. The liability of Rodman & Renshaw was predicated upon its failure to supervise this employee and it argued that the statute should begin to run from the time he left its employ since it could not thereafter be responsible for the cover-up of the fraudulent scheme.

The court first held that, notwithstanding the "look" to state law for the applicable limitation period, the running of the statute may be tolled by the tolling doctrine adopted by the federal courts in fraud actions, where the fraud has been actively concealed or is of a nature to conceal itself, until the plaintiff has obtained knowledge or, in the exercise of due care, should have obtained knowledge of the fraud.133

It then held that the tolling doctrine operates both against those who commit the fraudulent acts and those who by their negligence facilitate the fraud. Since plaintiffs did not learn of the fraudulent scheme until the criminal indictment in 1967, and since the scheme was concealed by those actively pursuing it, the complaint filed in 1969 was within the statute as tolled. In so doing, the court continued and extended the trend developed in Hochfelder v. Midwest Stock Exchange.134 However, with respect to AMEX and its specialists, who were added in 1972, more than three years after the criminal indictment, the court held that plaintiffs had not exercised due diligence, because the 1967 indictment put them on notice of the possibility of involvement by AMEX and discovery could have been had of the brokerage houses since the discovery was stayed only as to the indicted conspirators.135

In Tomera v. Galt,136 the court again looked to the reason why discovery of the fraud might be delayed and distinguished between fraud which goes undiscovered after its commission even though the defendant does nothing to conceal it and fraud which, after its commission, is actively concealed by the defendant. As to the former, it followed the prior decisions of the Seventh Circuit137 requiring plaintiffs to exercise due

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133. Id. at 1296, citing Judge Swygert's opinion in Hochfelder v. Midwest Stock Exchange, 503 F.2d 364, 375 (7th Cir. 1974).
134. 503 F.2d 364 (7th Cir. 1974).
135. 509 F.2d at 1299.
136. 511 F.2d 504 (7th Cir. 1975).
137. E.g., Morgan v. Koch, 419 F.2d 993 (7th Cir. 1969).
diligence in discovering the fraud. However, as to fraud which is actively concealed by the defendant, it held that the statute is tolled until actual discovery is made by the plaintiff.

In Tomera, the court looked to the activity of another plaintiff in seeking information and being rebuffed in every instance by defendants; it then concluded that "[w]hether plaintiff personally inquired into the business affairs of the two Mexican corporations is unimportant." In effect, Ms. Tomera was the "third party beneficiary" of another plaintiff's exercise of due diligence in seeking to ferret out the fraud.

As an abstract proposition, the notion that any active concealment of fraud after the commission thereof automatically tolls the statute indefinitely appears to be too open-ended. A basic policy underlying statutes of limitation is to have claims litigated before the evidence is lost or the recollections of witnesses dimmed through lapse of time. Carried to the extreme, Tomera would keep claims open forever. However, as limited to its facts, it is a reasonable approach. There will normally be no "after the fact" cover-up unless one plaintiff, in effect, exercises due diligence. Since this plaintiff will be in court, there appears to be no strong policy argument why the defendant should be able to escape liability vis-a-vis a less aggressive or diligent plaintiff.

**Attorneys' Fees**

Attorneys' fees in litigation are not ordinarily recoverable unless provided for by statute or by an enforceable contract. However, the courts, drawing on their historic equity powers, have developed several exceptions to this general rule. For example, a successful party to a lawsuit may be awarded attorneys' fees if the losing party has acted in bad faith or vexatiously.

Another judicially created exception permits an award of attorneys' fees to a plaintiff whose successful suit has benefited others not parties to the action. This exception was first recognized in cases where a plaintiff's success created a fund for the benefit of an entire group and was later extended in Mills v. Electric Auto-Lite Co. to a situation in a shareholders' derivative suit where no actual fund was created. The theory of this

138. 511 F.2d at 510.
approach was that if the plaintiff in the shareholder's derivative suit enforces a right for the benefit of the corporation, thereby benefiting all shareholders, it is proper that all shareholders bear the cost of bringing the action. When the corporate defendant is ordered to pay the attorneys' fees and other costs, the basis of the order is not the corporation's position as defendant but rather that this is the most efficient way to allocate costs among the benefited shareholders.\footnote{In Mills, the Supreme Court did not reach the question as to whether plaintiffs, having recovered attorneys' fees for establishing the existence of a violation of the securities laws, could recover additional fees for litigating the question of relief. It was to this latter issue that Judge Tone first addressed himself in Swanson v. American Consumer Industries, Inc. He held, quite logically, that if the expense of establishing the existence of a cause of action benefits the corporation and its shareholders, then the cost of litigation "establishing the effects of the violation" (the damages under the cause of action) must similarly benefit them. The defendants had argued that, since some members of the class had opted out of the litigation, they should be exempted from sharing the burden of the fees. This argument was rejected by the court on the ground that the basis for the suit was a derivative one. Since the corporation was benefited by establishing the violation of the securities laws, it must assume the cost on behalf of its shareholders.

The problem with this line of reasoning is that the suit was originally brought derivatively and as a class action. In Swanson II, the court in essence granted "class action" and not "derivative" relief. It acknowledged that the misleading proxy statement may have induced some shareholders to approve the sale, thereby resulting in a loss of their rights as dissenters or appraisers. Accordingly, it held that "the appropriate remedy is to restore to the plaintiff shareholders the opportunity to receive cash rather than ACI

\footnote{396 U.S. at 392, 396-97.}  
\footnote{As the court in Swanson v. American Consumer Indus., Inc., 517 F.2d 555 (7th Cir. 1975), stated:}  
\footnote{In Mills, an extension of Trustees v. Greenough, supra, the rationale for awarding fees was that the expense of prosecuting the action should be borne by those who benefited by the judgment. This was accomplished by having the corporation pay the fees, since all its shareholders thereby bore the cost equally with the benefit. This distribution of costs is "between solicitor and client," in terms of Trustees v. Greenough and not between the adverse parties to the case. It is in their role as former shareholders and as the successor corporations of the nominal defendant Peoria that ACI and U.S. Cold may have a portion of the attorneys' fees imposed upon them, not in their other role as defendants in this litigation.}  
\footnote{Id. at 560 (citation omitted).}  
\footnote{517 F.2d 555 (7th Cir. 1975) [hereinafter referred to as Swanson III].}  
\footnote{Id. at 562.}  
\footnote{475 F.2d 516 (7th Cir. 1973).}
The significance of this holding will become more apparent as the question of the amount of the fee is analyzed.

The district court allowed attorneys' fees in the amount of $21,336, together with full payment of expenses, but refused to permit recovery for time spent on issues upon which plaintiffs did not prevail. The appealing attorneys sought $89,377. Judge Tone held in *Swanson III* that it was error to exclude recovery for services in connection with issues upon which plaintiffs did not prevail although the failure to prevail upon certain issues could be taken into account, as could the modesty of the relief ultimately awarded plaintiffs and the amount "that could realistically have been hoped to be recoverable."\(^{152}\)

In reviewing the numbers, the court set forth $25,956 as the amount recovered by the shareholders who pursued the litigation, $16,200 as the amount that could have been recovered by the shareholders who opted out and an additional $25,000 as the amount that could have been recovered if the valuation set forth by plaintiffs' expert witness had been accepted.\(^{153}\) The court then concluded that $40,000 was an appropriate fee.\(^{154}\)

The facts of this case present a dilemma in commenting upon the appropriateness of the attorneys' fee award. The *Mills* case authorized the payment of fees where "corporate therapeutics" that provide "a benefit to all shareholders" are involved.\(^{155}\) But in *Swanson*, the majority shareholder, controlling 87 percent of the stock, was the culprit. The litigation certainly conferred no benefit upon it. Thus, only minority shareholders were benefited and only to the extent of $42,156. An attorneys' fee award of $40,000 appears out of proportion. On the other hand, a lesser award might discourage this type of litigation and this in turn would lead to the creation of the syndrome that the greater the control, the more the majority

151. Id. at 521.
152. 517 F.2d at 563. For recitation of factors used in determining attorneys' fees, see Schlesinger v. Wallace, CCH FED. SEC. L. REP. ¶ 94,098 (N.D. Ala. 1973), and 3B J. MOORE, FEDERAL PRACTICE ¶ 23.1.25 at 23.1-453 (2d ed. 1974):

[These factors] include the amount recovered for the corporation; the time fairly required to be spent on the case; the skill required and employed on the case considering the intricacy, novelty and complexity of the issues; the difficulty encountered in unearthing the facts; the skill and resourcefulness of opposing counsel; the prevailing rate of compensation for those with the skill, experience and standing of the attorneys, accountants or others involved; the benefits accruing to the public; and the contingent nature of the fees.


153. 517 F.2d at 563.
154. Id. at 564.
can take advantage of the minority because the amount recoverable by the minority would not justify an attorneys' fee sufficient to induce the undertaking of the litigation. As it was, doubling the attorneys' fee apparently produced compensation at a rather modest hourly rate. Thus Judge Tone may have been implicitly weighing the need for therapeutic litigation much more heavily than the modesty of the sums in dispute.

PROCEDURE

In SEC v. Savage, the Seventh Circuit was faced with an appeal from an order of the district court requiring compliance with a subpoena duces tecum issued by the SEC. The respondents were engaged in the commodity futures business and were being investigated by the SEC to determine whether they had violated either the registration or anti-fraud provisions of the federal securities laws. The respondents resisted the subpoena on the basis that the SEC must first establish its jurisdiction by demonstrating that the commodity futures contracts are securities within the meaning of the securities laws. In a per curiam opinion affirming the order of the district court requiring compliance with the subpoena, the court pointed out that part of the purpose of the investigation was to determine whether or not the respondents' course of business did in fact involve a security. As the court stated, "the appellants [respondents] would require SEC to answer at the outset of its investigation the possibly doubtful questions of fact and law that the investigation is designed and authorized to illuminate." The Seventh Circuit followed the reasoning of the United States Supreme Court in Oklahoma Press Publishing Co. v. Walling, where the court analogized an administrative agency's investigatory function to the action of the grand jury and held that such inquiry is not to be limited by forecasts of the probable results of the investigation. The Second Circuit, in two recently decided opinions involving the investigatory power of the Securities and Exchange Commission, has likewise refused to limit the SEC's authority.

In King v. Kansas City Southern Industries, Inc., the Seventh Circuit had under consideration an appeal by plaintiffs from the order of the district court denying them class action status and approving a proposed settlement
agreement. The litigation arose out of a Rosenfeld v. Black\textsuperscript{162} type situation in which shareholders of a mutual fund were deceived through a misleading proxy statement into approving, in effect, the sale of the mutual fund advisor at a profit.

Class action, derivative and direct actions were brought and the district court denied class action status to the Kings as shareholders of the fund, stayed the derivative actions and let the direct action proceed with opportunity for shareholders of the fund to intervene to insure an adversary proceeding. Judge Sprecher held that this was a practical decision to be left to the discretion of the lower court and affirmed. He further held that the Kings were estopped from challenging the settlement since they had agreed to the amount and were challenging only the question of the proper beneficiary.

McGough v. First Arlington National Bank\textsuperscript{163} involved a rather confused situation involving the purchase of a car-wash by plaintiff, the financing of it by defendant, the lease of the car-wash back to the seller and the sublease by the seller to an operator. The venture collapsed and the plaintiff was sued by defendant in state court on the note, whereupon he sued in federal court seeking recission on the basis that the transaction involved a security and that the securities laws were violated in connection with the sale thereof. The district court refused to restrain the state court action and stayed the district court proceeding.\textsuperscript{164} The Seventh Circuit affirmed the refusal to restrain the state court proceeding but reversed the stay of the district court proceeding, commenting: "We deem it regrettable that these two proceedings should be progressing on separate courses, each racing to a conclusion before the other, which in their respective postures can be satisfactorily resolved to no one."\textsuperscript{165}

It cannot be gainsaid that it is undesirable for both actions to proceed. Accordingly, if, as the Seventh Circuit has held,\textsuperscript{166} a securities claim can be asserted as a defense in a state court proceeding even though it could not have been initiated there because of the exclusive jurisdiction conferred upon federal courts,\textsuperscript{167} it did not make sense to reverse the stay of the district court action.

**CONCLUSION**

As indicated at the beginning of this article, during the past term the United States Supreme Court has explicitly or implicitly overruled two earlier

\textsuperscript{162} 445 F.2d 1337 (2d Cir. 1971).
\textsuperscript{163} 519 F.2d 552 (7th Cir. 1975).
\textsuperscript{164} Id. at 554.
\textsuperscript{165} Id. at 555.
\textsuperscript{166} Aetna State Bank v. Altheimer, 430 F.2d 750 (7th Cir. 1970).
\textsuperscript{167} 15 U.S.C. § 78aa (1970) provides that the "district courts . . . shall have exclusive jurisdiction of violations of this title or the rules and regulations thereunder."
decisions of the Seventh Circuit. In the opinion of this author, the Seventh Circuit's treatment of the Birnbaum and Schedule 13D problems in Eason and Mosinee Paper, respectively, represented clearer judicial insight into the purposes of the federal securities laws, and the appropriate implementation thereof, than did the Supreme Court's decisions in Blue Chip Stamps and Mosinee Paper. With respect to the decisions of the Seventh Circuit itself this past year, neither the problems which arose nor the judicial treatment thereof were particularly unique. While there were areas treated in the Seventh Circuit for the first time, the overall effect of its work this past year has been to add breadth more than depth to the body of law in the securities field. In so doing, however, the Seventh Circuit has continued to manifest an appreciation for the underlying purposes of the securities laws and a sophistication in dealing straight-forwardly with the complex problems in this area.