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Securities: An Analysis of the Seventh Circuit Decisions during the 1984-85 Term

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The Securities Act of 1933\(^1\) and the Securities and Exchange Act of 1934\(^2\) were enacted by Congress with the intention of providing protections for securities investors.\(^3\) The case law interpreting the Securities Acts is a large and continuously changing body of law. In its 1984-85 term, the Seventh Circuit decided a number of cases which contribute significantly to securities law. The decisions of the Seventh Circuit indicate a willingness on the part of the court to provide remedies for injured investors. On the other hand, the court demonstrated an unwillingness to extend coverage of the Acts beyond their intended proscriptions. This article will analyze seven of the more significant cases decided by the Seventh Circuit during its 1984-85 term and examine the implications of those decisions.

The decisions examined in this article span a variety of areas. This article will begin with a discussion of a case in which the Seventh Circuit was called upon to determine whether a Rule 10b-5 plaintiff has a duty to investigate the misrepresentations of a defendant. Next, the decision of the Seventh Circuit to refuse to vary the standards for reopening a judgment under \textit{Fed. R. Civ. P.} 60(b) will be examined to the extent that the decision implicates the question of whether an implied right of action exists under Rule 10b-5 in court approved securities transactions. Then, the Seventh Circuit’s acceptance of the sale of business doctrine will be considered in light of the United States Supreme Court’s subsequent rejection of the doctrine.

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\footnote{The author wishes to express her appreciation to Roger Carlson for his contribution to this article.}

3. \textit{See Federal Securities Act, 1933: Hearings on H.R. 4314 Before the Comm. on Interstate and Foreign Commerce, 73rd Cong., 1st Sess. 1 (1933) (statement of Franklin D. Roosevelt, President of the United States of America), reprinted in 2 \textit{Ellenberger \& Mahan, Legislative History: Securities Act 1933}, Item 20 (1973) (emphasizing the need for disclosure in order to protect securities investors); see also S. REP. NO. 792, 73rd Cong., 2d Sess. 3 (1934), reprinted in 5 \textit{Ellenberger \& Mahan, Legislative History: Securities and Exchange Act 1934}, Item 17 (1973) (discussing the need to regulate excessive speculation and manipulative practices employed in the securities markets in order to protect investors).}
This article will also discuss a case in which the Seventh Circuit concluded that an instrument, which qualifies as a note within the meaning of the Securities Acts, does not also have to qualify as an investment contract in order to constitute a security. Further, the court’s stance on the federal courts’ duty to compel arbitration of state securities claims will be evaluated in light of a recent Supreme Court decision. Lastly, this article will examine two cases in which the Seventh Circuit reached outside of the Securities Acts in order to extend the potential liability of securities and commodities dealers.

**RULE 10b-5: PLAINTIFF’S DUTY TO INVESTIGATE**

Rule 10b-5, promulgated under section 10(b) of the 1934 Act, is a broad antifraud provision designed to prohibit fraudulent and manipulative practices employed in connection with the sale of securities. In drafting Rule 10b-5, the Securities and Exchange Commission (SEC) declined to establish the elements of the 10b-5 offense. Consequently, the courts were left with the responsibility of carving out the elements of Rule 10b-5. One element, recognized by some courts, was the duty to investigate. These courts imposed a duty on an investor, who was seeking to recover under Rule 10b-5 for the defendant’s misrepresentations and omissions of material fact, to investigate the truthfulness of the defendant’s representations. Although most courts no longer impose such a duty on plaintiffs in Rule 10b-5 cases, the issue still arises as Teamsters Local 282 Pension Plan v. Angelos, decided by the Seventh Circuit in its 1984-85 term illustrates.

Consistent with most of the other elements of a private right of action under Rule 10b-5, the duty to investigate has its basis in common law. The duty stems from the defense of contributory negligence recognized under the law of negligent misrepresentation. The rationale for

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4. Section 10(b) of the 1934 Act grants the SEC the broad power to impose rules with which to combat fraudulent practices. 15 U.S.C. § 78j(b) (1982). Pursuant to this grant of authority, the SEC adopted Rule 10b-5. 17 C.F.R. § 240.10b-5 (1975).
5. See Ernst & Ernst v. Hochfelder, 425 U.S. 185, 203 (1975) (discussing Congress’ intent in enacting § 10(b)).
8. Id.
9. See infra note 15 and accompanying text.
10. 762 F.2d 522, 527 (7th Cir. 1985).
imposing the duty is that a plaintiff should not be able to "successfully maintain a private 10b-5 action if his own carelessness has contributed to his loss." The courts imposed the duty in cases where the defendant's conduct was merely negligent. However, in congruence with the common law, the courts refrained from imposing the duty when the defendant's conduct was intentional. Thus, after Ernst & Ernst v. Hochfelder, in which the Supreme Court held Rule 10b-5 requires scienter, few courts have recognized the duty in Rule 10b-5 cases.

Although the duty to investigate is no longer generally accepted as an element of Rule 10b-5, the issue of whether an investor has a duty to investigate still arises because courts have intertwined the concept of the duty with other elements of a Rule 10b-5 action. For example, some courts have analyzed the duty to investigate in terms of reasonable reliance which is a requisite element under Rule 10b-5. These courts reasoned that it may be unreasonable for an investor to rely on the representations of a defendant without conducting an investigation particularly where the investor has the means to do so. In Angelos, the Seventh Circuit addressed the issue of whether the trustees of a pension fund reasonably relied upon the misrepresentations of the defendant where the trustees had a legal obligation to investigate such misrepresentations under ERISA but failed to do so. The Seventh Circuit determined that

13. Id.
14. Id. at 577-83.
15. See Sundstrand Corp. v. Sun Chem. Corp., 553 F.2d 1033, 1048 (7th Cir. 1977); Holdsworth v. Strong, 545 F.2d 587, 593-94 (10th Cir. 1976), cert. denied, 430 U.S. 955 (1977); Competitive Assoc., Inc., v. Laventhal, Krekstein, Horwath & Horwath, 516 F.2d 811, 814 (2d Cir. 1975). See also Wheeler, supra note 6, at 576-77 (discussing the courts reluctance to impose a duty in cases where the defendant's conduct was intentional). But cf. Dupuy v. Dupuy, 551 F.2d 1005, 1015-20 (5th Cir.), cert. denied, 434 U.S. 911 (1977) (holding that, although an investor does have a duty to investigate even where the defendant's conduct was intentional, the investor's failure to do so will only preclude his recovery if, under the circumstances, his failure to investigate renders him as culpable as the defendant).
17. See supra note 15 and accompanying text.
18. See Wheeler, supra note 6, at 570-75. Some courts did treat the duty as an independent element. See id. at 574; Dupuy, 551 F.2d at 1016. However, other courts linked the duty to the requirement of reasonable reliance. See Holdsworth, 545 F.2d at 694 (while determining that an investor does not generally have the duty to investigate under Rule 10b-5, the Holdsworth court left open the possibility that in some circumstances the investor's duty to investigate may bear on the issue of whether he reasonably relied); see Wheeler, supra note 6, at 570. Other courts have incorporated the duty into the defendant's duty to disclose. Wheeler, supra note 6, at 572.
19. See supra note 18.
20. Reasonable reliance is an element of Rule 10b-5. See Haggerty, Fraud on the Market: The Decline of Reliance in a 10b-5 Action, 12 GOLDEN GATE 407, 411-14 (1982). However, the Supreme Court has held that positive proof of reliance is not necessary in cases involving omissions of material fact. See Affiliated UTE Citizens v. United States, 406 U.S. 128, 153-54 (1972). For the reason that most misrepresentation cases can be recharacterized as omission cases, doubt has arisen as to the continued viability of the reliance requirement. See generally Haggerty, supra.
the trustees' obligation under ERISA was irrelevant to the determination of whether they reasonably relied within the meaning of Rule 10b-5.

In Angelos, the trustees of Teamsters Local 282 Pension Trustfund (Fund) loaned $200,000 to Des Plaines Bancorporation, Inc. (Bank) in early 1979. The trustees were not equipped to evaluate the soundness of the loan and did not obtain outside assistance. The Bank officials materially misrepresented the financial condition of the bank. In truth, the Bank was experiencing serious financial troubles and, in March 1981, state regulatory officials closed the bank.

The Fund first brought suit in New York against the trustees claiming that the trustees violated their duties to the beneficiaries of the Fund. The New York district court held, and the Second Circuit affirmed, that a reasonable investigation would have revealed the "shaky status" of the Bank, and the trustees' failure to conduct an investigation constituted a breach of the duty imposed by ERISA.

The Fund subsequently brought suit in the District Court of Northern Illinois against the Bank, and the law firm representing the Bank in making the loan, claiming that they violated Rule 10b-5 and other provisions of the Securities Acts. The District Court found that it was bound by the findings of the New York District Court and granted summary judgment for the defendants holding that the trustees' failure to adequately investigate the Bank before making the loan, thereby breaching their fiduciary duties, precluded them from relying on the defendant's misrepresentations. The Seventh Circuit reversed.

The Seventh Circuit found that the trustees' duty under ERISA was irrelevant with respect to whether the trustees had reasonably relied on the defendants' misrepresentations. The Seventh Circuit premised its reasoning on the general rule that an ordinary investor is under no duty

21. During the course of the New York litigation, the trustees of the fund filed a third-party complaint against the bank directors and the law firm which represented the bank in making the loan (collectively "defendants"). The complaint charged that the defendants had defrauded the trustees. The New York court dismissed the complaint holding that the arguments should be raised in independent litigation.


23. In addition to the issue of whether a 10b-5 plaintiff has a duty to investigate, the Seventh Circuit addressed several other issues raised in the Angelos case. First, the court upheld the district court's determination that it was bound by the New York court's findings of fact. See 762 F.2d at 525-26. Second, the court declined to determine whether an implied right of action exists under § 17(a) of the 1933 Act. Id. at 530-31. Third, although the court did not decide the Illinois negligent misrepresentation claim, it noted that the duty to investigate under the Illinois law may be greater than under Rule 10b-5. Id. at 531. And fourth, the Seventh Circuit, in remanding the case, instructed the district court to first determine whether the loan at issue constituted a security and, if so, whether the defendants possessed the requisite scienter. Id. at 532.
to investigate. The court concluded that the duty imposed by ERISA on trustees of pension plans was designed to compel the trustees to exercise the same degree of care in investing the assets of the Fund as they would exercise in investing their own funds. Thus, the trustees' duty to investigate under Rule 10b-5 is no different than that of the ordinary investor. The court reasoned that the duty imposed under ERISA is merely another legal safeguard designed by Congress to protect the beneficiaries of pension plans. The failure of the trustees to comply with their duty does not excuse the defendants from complying with their legal obligation to tell the truth.

Judge Easterbrook, writing for the majority, offered the defendants two arguments with which to respond to the court's above conclusion, but went on to determine that neither argument was persuasive. First, the defendants could analogize to the common law of torts and claim that the trustees were contributorily negligent. However, Judge Easterbrook pointed out that contributory negligence is not a defense to an intentional tort which, after Hochfelder, includes Rule 10b-5. Therefore, the defense was not available under the circumstances. Second, the defendants could analogize to third-party beneficiary contracts and claim that they were not the intended beneficiaries of ERISA. However, because the defendants were not the intended beneficiaries of ERISA, this argument was similarly unavailing.

Lastly, the court rejected the defendant's contention that, in order to satisfy the reasonable reliance requirement all investors who purchase securities in large, privately negotiated transactions must conduct an investigation. The court found that the argument failed "to give the seller's obligation to tell the truth the primacy that it must have." The court noted that other courts had similarly rejected the contention that a buyer's failure to exercise due care or diligence is a defense in intentional fraud cases. Further, the court determined that the policy considerations do not promote such a rule. The court found that imposition of a duty to investigate would in turn impose costs on all investors to perform such an investigation while, at the same time, set the "would-be tortfeasor" free to commit misrepresentations without fear of liability.

The Seventh Circuit took care to note that Rule 10b-5 does not impose absolute liability. In order to recover, an investor must establish that it was reasonable to rely on the defendant's representations. In some circumstances, the mere fact that a defendant made misrepresentations

24. Id. at 528.
25. Id.
or omissions of material fact is not enough, in itself, to establish reasonable reliance. The court specified three circumstances in which reasonable reliance may not be established. First, if the investor receives a writing which explicitly discloses the risks but is told orally that there are no risks, then it is unreasonable for the investor to rely on the misrepresentation because he holds the truth in his hands. Second, if the investor is aware of the risks, and the defendant's representations do not dispel them, then the investor's reliance is unreasonable unless "there is a substantial likelihood that the misrepresentation significantly altered the total mix of the information that the investor possesse[d]." 26 And third, if the misrepresentation or omission concerns matters known to the investor equally or better than to the defendant, then it is unreasonable for the investor to rely on the misrepresentations. The court determined that the situation presented in the Angelos case did not fall into any of these categories.

The Seventh Circuit's decision in Angelos was well reasoned and proper. Congress enacted ERISA and section 10(b) with the express intention of protecting pension fund beneficiaries and investors in general. As the court pointed out, it would be plainly contrary to Congress's intent to hold that the failure of one legal safeguard excuses the failure of the other. However, the duty to investigate will still be important in Rule 10b-5 cases even though it may not be expressly referred to. In privately negotiated transactions in particular, the reasonableness of failing to investigate will always be implicit in the issue of reasonable reliance.

**Implied Private Right of Action Under Rule 10b-5 in Court-Approved Securities Transactions**

Enforcement of Rule 10b-5 is largely achieved through private civil actions. Although the Rule does not expressly provide a private right of action, it is well settled that an implied private right of action exists. 27 In fact, the United States Supreme Court has recently held that an investor has an implied right of action under Rule 10b-5 for misstatements contained in a registration statement filed in compliance with the 1933 Act, even where such investor has an express right of action under section 11 of the 1933 Act. 28 Given the Supreme Court's undaunted acceptance of an implied right of action under Rule 10b-5, one would expect that an

26. Id. at 530 (quoting TSC Indus., Inc. v. Northway, Inc., 426 U.S. 438, 449 (1976)).
27. Herman & MacLean v. Huddleston, 459 U.S. 375, 380 (1983). The Court stated "The existence of this implied remedy is simply beyond peradventure." Id.
28. Id.
implied right of action would be recognized wherever fraud has been practiced in connection with a securities transaction. However, the Seventh Circuit, in *Metlyn Realty Corp. v. Esmark*,29 indicated that this may not be the case with respect to securities transactions which are approved by a court.

In *Metlyn*, Esmark, Inc. owned a controlling interest in TransOcean Oil, Inc. and decided to acquire the rest. Esmark made a tender offer of $12 per share. The tender offer raised Esmark's ownership of TransOcean to 87.5%. Four groups of TransOcean shareholders brought four separate suits alleging that Esmark violated its duty to disclose its internal valuations showing that TransOcean was worth more than $12 per share. One group of shareholders reached a settlement.

The settlement provided that Esmark would pay the TransOcean shareholders, who had previously accepted the tender offer, an additional $2.80 per share. Additionally, Esmark would exchange 0.9 shares of Esmark stock for one share of TransOcean stock with the TransOcean shareholders who still held their shares. The settlement agreement was conditioned upon judicial determination that the terms were fair. After a hearing, the District Court found that the terms were fair and subsequently TransOcean merged with Esmark.

Less than one year later, Esmark sold TransOcean to Mobil for $60 per share. The shareholders, who were parties to the settlement agreement, sought to reopen the judgment under *FED. R. Civ. P. 60(b)* on the grounds that Esmark had withheld from the court its plans to resell TransOcean, and that Esmark's expert witness lied regarding certain material facts upon which his opinion as to the value of the stock was based. The District Court denied the motion.

The standards for reopening a judgment under Rule 60(b) are stringent. Rule 60(b) allows a court to reopen a case for fraud, misrepresentation or other misconduct of a party.30 A movant under 60(b) must establish fraud by clear and convincing evidence.31 Further, unless the movant can prove that the adverse party procurred or knew of the false testimony, the motion must be denied unless the fraud created a substantial danger of an unjust result.32 Moreover, the decision of a district

29. 763 F.2d 826 (7th Cir. 1985).
30. Other grounds for reopening a final judgment under Rule 60(b) are: mistake, inadvertence, surprise, or excusable neglect; newly discovered evidence which by due diligence could not have been discovered in time to move for a new trial under *FED. R. Civ. P. 59(b)*; judgment is void, judgment has been satisfied, released, or any other reason justifying relief from the operation of judgment.
31. 763 F.2d at 832.
32. *Id.* (quoting *Merit Ins. Co. v. Leatherby Ins. Co.*, 714 F.2d 673, 682-83 (7th Cir. 1983), *cert. denied*, 464 U.S. 1009 (1984)).
court declining to reopen judgment under Rule 60(b) may be reviewed only for abuse of discretion. Such a decision is attributed the greatest deference where that court is the same court in which the alleged fraud occurred.33

At the hearing, it had been established that neither Esmark nor its counsel knew that their witness’s statements were false. The Seventh Circuit concluded that the witness’s lies did not create substantial danger of an unjust result because there was other evidence upon which the the district court could have based its conclusion that the terms were fair. In particular, the Seventh Circuit attributed great weight to the market price at the time of the original hearing. Accordingly, the Seventh Circuit concluded that the district court properly denied the motion to reopen judgment.

The shareholders contended that the standards under Rule 60(b) should be relaxed in securities cases because the standards for deducing fraud under Rule 10b-5 are less stringent. The Seventh Circuit noted that the case did not involve an implied right of action under Rule 10b-5, nonetheless, the court found that many of the same principles for deducing the existence of an implied right of action applied.34

In applying those principles, the court found that it was “quite far-fetched to suppose that Congress meant to change the rules of civil litigation when it enacted the Securities Act of 1933 and authorized the SEC to promulgate Rule 10b-5 under the 1934 Act.”35 Further, the court found that relaxing the standards under Rule 60(b) would interfere with the principles, developed under the Rule, which are “tuned to the benefits and burdens of reopening judgments.”36 For these reasons, the court refused to vary the standards under Rule 60(b). The court stated that these standards constituted the “sole means of attack on final civil judgments.”37

It is plain that the Seventh Circuit’s application of Rule 60(b) in

33. Id. at 831. The district court which refused to reopen the judgment was the same court which had determined that the terms of the settlement agreement were fair in the original hearing. In refusing to reopen judgment, the district court determined that the expert witness’ misstatements had been adequately challenged at the hearing and found no evidence of fraud or deliberate deceit. Further, it determined that the witness’ misstatements had not affected its determination. The Seventh Circuit concluded that these factors made the movants’ task more difficult than the general requirement of establishing that the district court abused its discretion. Additionally, the Seventh Circuit noted that “deference is never greater than when the underlying judgment is a settlement.” Id.

34. Id. at 833.
35. Id.
36. Id.
37. Id.
Metlyn was proper. However, the court's analogy to the existence of an implied right of action under Rule 10b-5 is troubling. The court's decision implies that no implied private right of action under Rule 10b-5 exists for fraud practiced in connection with a court-approved securities transaction.\(^{38}\) This implication is troubling because it necessarily restricts the protection afforded to the parties of such a transaction under the Securities Acts. For example, the standards for reopening a case under Rule 60(b) are significantly stricter than the standards for establishing a violation of Rule 10b-5. In particular, the standard of proof required under Rule 60(b) is clear and convincing evidence\(^ {39}\) whereas the Supreme Court has specifically rejected such a stringent standard under 10b-5 and requires only a preponderance of the evidence.\(^ {40}\) Thus, investors injured in a court-approved securities transaction would bear a higher burden of proof in order to recover if an implied right of action is recognized. Consequently, the Securities Acts would afford such investors less protection than the investor in an ordinary securities transaction.

The issue of whether an implied right of action under Rule 10b-5 exists in this context was not directly raised in Metlyn, and therefore, the case may have little bearing on the ultimate determination of the issue. However, the Metlyn court introduced a new wrinkle to the implied right of action analysis—the existence of a conflict between the principles underlying Rule 60(b) and Rule 10b-5. Consequently, when the Seventh Circuit does address the implied right of action issue, it may very well have to consider the Metlyn concerns.

Another important aspect of the court's decision in Metlyn is the court’s determination that the price of TransOcean stock at the time of the hearing was entitled to great weight by the district court in determining whether the terms of the settlement agreement were fair. The district court had determined that, due to the proposed merger, the market price was unreliable. However, the Seventh Circuit found that “[the price] reflected not only the value of a merger but also the value investors would have had in the absence of a merger, which was not a certainty,” and thus was some evidence of the true value of the stock.\(^ {41}\) Metlyn indicates

\(^{38}\) Section 3(a)(10) of the Securities Act of 1933 exempts distributions of securities which are approved by a court or in certain administrative proceedings from the registration provisions of the Act. It does not exempt such distributions from the antifraud provisions. 15 U.S.C. § 77c(a)(10) (1982).

\(^{39}\) 763 F.2d at 832 (quoting Ervin v. Wilkinson, 701 F.2d 59, 61 (7th Cir. 1983)).

\(^{40}\) Herman & MacLean, 459 U.S. at 387-91.

\(^{41}\) 763 F.2d at 835.
that the Seventh Circuit will attribute significant weight to market value in determining the value of securities in the future.

THE SALE OF BUSINESS DOCTRINE

The registration and antifraud provisions of the Securities Acts are not applicable to instruments which are not securities. Thus, the starting point of any securities case is the determination of whether the particular instrument constitutes a security within the meaning of the Securities Acts. Section 2 of the 1933 Act\textsuperscript{42} and section 3 of the 1934 Act\textsuperscript{43} provide the definition of a security. These provisions designate specific instruments as securities, including stock, notes, investment contracts and others. \textit{Christison v. Groen},\textsuperscript{44} decided by the Seventh Circuit in its 1984-85 term, raised the issue of whether the controlling interest of stock of a corporation constitutes a security within the meaning of the Securities Acts.

Until recently, the United States Courts of Appeals have been in dispute as to whether a transaction involving the sale of 100% of the stock of a corporation constituted a sale of securities within the meaning of the Securities Acts.\textsuperscript{45} Many circuits had adopted what is known as the sale of business doctrine, which provides that the sale of 100% of the stock of a corporation is not a sale of securities.\textsuperscript{46} In \textit{Christison v. Groen}, the Seventh Circuit reaffirmed its acceptance of the doctrine. However, subsequent to the Seventh Circuit’s decision of \textit{Christison}, the United States Supreme Court rejected the sale of business doctrine in \textit{Landreth Timber Co. v. Landreth},\textsuperscript{47} and held that the sale of the controlling interest of stock of a corporation is a sale of securities within the meaning of the Securities Acts. It is readily apparent that the \textit{Landreth} case will have a significant impact on the application of the Securities Acts. An examination of the \textit{Landreth} decision and the rationale underlying the now extinct sale of business doctrine applied by the Seventh Circuit in \textit{Christison} may provide insight into the Seventh Circuit’s analysis of other securities in other contexts.

\textsuperscript{44} 740 F.2d 593 (7th Cir. 1984).
\textsuperscript{47} 105 S. Ct. 2297 (1985).
The sale of business doctrine, as accepted by the Seventh Circuit, stems from the court’s interpretation of SEC v. W.J. Howey Co.,48 and United Housing Foundation, Inc. v. Forman.49 In Howey, the Supreme Court held that a partition of an orange grove coupled with a contract for the cultivation of the grove was an investment contract, and therefore a security. In so holding, the Court devised a test: a “contract, transaction or scheme whereby a person invests his money in a common enterprise and is led to expect profits from the efforts of the promoter or a third party” is an investment contract within the meaning of the Securities Acts.50

In Forman, the Court was confronted with a situation in which the plaintiffs held instruments which were labeled “stock” but which merely entitled the plaintiffs to lease residential space in an apartment complex. The Supreme Court first determined that the instrument did not possess any of the characteristics of traditional stock.51 The Court then went on to determine whether the instrument satisfied the Howey test. In finding that the Howey test was not met, and that therefore the instrument was not a security, the Court stated that the Howey test “embodies all the essential attributes that run through all the Court’s decisions defining a security.”52

In cases involving the sale of a controlling interest of stock of a corporation, the Seventh Circuit interpreted Howey and Forman as providing a general rule that an interest is not a security unless it satisfies the Howey test.53 Accordingly, the court concluded that the sale of 100% of the stock of a corporation is not a security because the purchaser can exert control and if the purchaser intends to do so, then that purchaser is not investing with the expectation that profits will be derived from the entrepreneurial or managerial efforts of others. Thus, the sale of business doctrine emerged.

In 1981, the Seventh Circuit, in Frederickson v. Poloway,54 expanded the scope of the sale of business doctrine by finding that the sale of less than 100% of the stock of a business does not involve a securities transaction if it is a commercial as opposed to an investment venture. The

50. 328 U.S. at 298-99.
51. 421 U.S. at 851.
52. Id. at 852.
53. Emisco Indus., Inc. v. Pro's Inc., 543 F.2d 38 (7th Cir. 1976). The court stated: "reliance on the efforts of others to produce a profit is the most important aspect of an investment, which, in turn, is an essential characteristic of transactions intended to be protected by the federal securities laws." Id. at 41.
Seventh Circuit determined that a transaction is a commercial venture if the purchaser can and intends to exert control over the purchased business. In 1982, in *Sutter v. Groen*, the Seventh Circuit further expanded the doctrine by creating a presumption of the purchaser's intent to control where the purchase involves more than 50% of the company's stock. In *Christison*, the Seventh Circuit reaffirmed its acceptance of the doctrine and the presumption of commerciality.

In *Christison*, Sutter owned 70% of Happy Radio Company. Prior to Sutter's purchase of the Happy Radio stock, Happy Radio entered into an agreement to purchase 100% of Bret Broadcasting Company over a twelve year period. Christison, the trustee of the bankrupt estate of Sutter, alleged that the defendants, the Groens, who sold Bret Broadcasting to Happy Radio, misrepresented Bret's earnings in violation of the antifraud provisions of the Securities Acts. The issue before the Seventh Circuit was whether Sutter's purchase of 70% of Happy Radio constituted a securities transaction within the meaning of the Securities Acts. The Seventh Circuit applied the sale of business doctrine and the presumption of commerciality and held that it did not.

The *Landreth* case presented essentially the same issue—whether the sale of 100% of the stock of a corporation constituted the sale of securities within the meaning of the Securities Acts. The Ninth Circuit affirmed the district court's application of the sale of business doctrine and determined that the sale was not a securities transaction. The Supreme Court reversed and in so doing, expressly rejected the sale of business doctrine. Consequently, the *Landreth* decision effectively overruled *Christison*.

The *Landreth* Court held that stock is a category of security specifically listed in the Securities Acts which is provable by its characteristics. The characteristics of stock include the right to receive dividends contingent upon an apportionment of profits, negotiability, pledgability, voting rights in proportion to the number of shares owned, and potential for appreciation. The Court concluded that the stock in question possessed all these characteristics and therefore was a security within the meaning of the Securities Acts.

The Court disagreed with the contention that the *Howey* test must

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55. 687 F.2d 197 (7th Cir. 1982) (This was the first appeal of Christison v. Groen, 740 F.2d 593 (7th Cir. 1984). Sutter went into bankruptcy sometime after the first appeal. Christison was appointed trustee of Sutter's bankrupt estate).
57. 105 S. Ct. at 2304.
58. *Id.* at 2302.
be satisfied in order for any instrument to constitute a security. The Court pointed out that the Securities Acts designate various instruments as securities, including stocks, notes, investment contracts and others. The Howey test is applied in order to determine whether a particular interest is an investment contract and applies only in cases involving unusual instruments. Consequently, where the interest involved is traditional stock, there is no need to determine whether it is also an investment contract.

The Court cautioned that its holding—treating stock as a specific category of security provable by its characteristics—could not automatically be extended to other categories of securities specifically listed in the Acts. In particular, the Supreme Court indicated that its test could not be applied to notes. The court determined that stock is readily distinguishable from notes, as well as other categories of securities, in that there is a high expectation among purchasers of stock that they will be protected by the Securities Acts. Further, stock is relatively easy to identify because it lends itself to a consistent definition. The Court also pointed out that a "note" is a "relatively broad term that encompasses instruments with widely varying characteristics."

The Court noted that there are strong policy reasons for rejecting the sale of business doctrine. First, even in cases involving the transfer of 100% of the stock of a corporation, a purchaser may not intend to exert control but rather act as a passive investor. Some commentators believe that such an investor is entitled to the protections of the Securities Acts. Second, and more importantly, in cases in which the transfer is of less than 100% of the stock of the corporation, the application of the doctrine depends upon the determination that the purchaser actually obtained control. Under the doctrine, parties could not know whether they are covered by the Securities Acts until after extended discovery and litigation.

The Seventh Circuit's decision in Pierson v. Dean, Witter, Reynolds, Inc. demonstrates that the court continues to view the commercial nature of an instrument essential to the determination of whether the instrument constitutes a security. However, the Landreth case calls into

59. Id. at 2304.
60. Id.
61. Id. at 2306. The defendants in Byrd appeared to have emphasized the general concern that the Securities Acts should not be read so expansively so as to encompass ordinary commercial bank loans and other similar instruments.
62. Id. at 2306.
63. Id.
64. 742 F.2d 334 (7th Cir. 1984). See infra notes 82-86 and accompanying text.
question the continued viability of this view particularly if other categories of securities designated in the Acts are found to be provable by their characteristics. It is unclear whether the Supreme Court's test in Landerth will be extended to other categories of securities listed in the Securities Acts. However, the Supreme Court indicated that some of the factors which will be important in determining whether the test will be extended to a particular security are: the extent to which the security is easy to identify; whether the interest is such that a reasonable investor would expect to be protected; and whether the application of the test would unnecessarily expand the application of the Securities Acts. It will be interesting to see whether, in the future, the courts will find that other securities are provable by their characteristics.

**Fixed Interest Bearing Notes as Securities**

In *Hussinger v. Rockford Business Credits*, the Seventh Circuit again addressed the issue of what constitutes a security within the meaning of the Securities Acts. In particular, *Hussinger* involved the definition of a note. Two aspects of the court's decision in *Hussinger* are significant. First, the Seventh Circuit determined that a note does not have to satisfy the *Howey* test in order to constitute a security. And second, the court found that under its interpretation of the Supreme Court's analysis of the *Howey* test, instruments bearing fixed rates of return do not satisfy the "profits" element of *Howey*.

In *Hussinger*, Rockford Business Credits, Inc. (RBC), solicited 39 members of the general public and through the sale of instruments labelled "notes", raised $2,000,000 for its general business needs. Hussinger, a trustee of an employee profit sharing trust, purchased a $30,000 note from RBC for the trust. The note bore an interest rate of one percent above the prime rate and was to mature in one year. Prior to the stated maturity date, Hussinger tendered the note for redemption. RBC dishonored the note and Hussinger brought suit alleging various violations of the Securities Acts.

The district court dismissed the complaint on the ground that the note did not constitute a security within the meaning of the Securities Acts. The district court looked primarily to the fact that the instrument bore a fixed rate of interest and the note's term to maturity was less than one year. The court determined that since the rate of return that Hussinger was entitled to receive did not depend upon the success or failure of the enterprise, the instrument was not a security.

65. 745 F.2d 484 (7th Cir. 1984).
The Seventh Circuit found that the district court erred in relying on these factors in determining whether the note was a security and reversed. The court found that the relevant test is the commercial/investment test.\(^\text{66}\) Under the commercial/investment test, a note constitutes a security if it is an investment as opposed to a commercial transaction.\(^\text{67}\) In determining whether the note is an investment, the surrounding factual circumstances must be considered.\(^\text{68}\) However, those factors which are equally characteristic of investments and commercial enterprises are not useful to the determination. The court found that the presence of a fixed rate of interest and a short term to maturity were not useful factors because they are "neutral among alternatives."\(^\text{69}\) Therefore, the Seventh Circuit held that the district court erred in relying on these factors. In remanding the case, the Seventh Circuit instructed the district court to consider the manner of solicitation, the persons solicited, the magnitude of the distribution, and other factors relating to the commercial nature of the transaction.\(^\text{70}\)

Although the Seventh Circuit, by determining that the district court incorrectly applied the commercial/investment test, resolved the issue on appeal, the court went on to discuss RBC's other contentions. RBC contended that the district court properly dismissed Hussinger's complaint because the note at issue did not constitute an investment contract under Howey. In particular, RBC contended that fixed interest payments cannot satisfy the profits element of the Howey test.

The Seventh Circuit first rejected RBC's contention that the note must satisfy the Howey investment contract test in order to constitute a security within the meaning of the Securities Acts. The Seventh Circuit concluded that, because notes are specifically designated as securities within the Acts, an instrument which qualifies as a note under the commercial/investment test, does not also have to qualify as an investment contract under the Howey test. The court noted that in Forman, the Supreme Court first determined whether the instrument at issue, which was labeled stock, possessed the characteristics of traditional stock. Only after the Court determined that the instrument was not stock, did the Court apply the Howey test.\(^\text{71}\) The Seventh Circuit concluded that the Forman Court implied that an instrument that does not satisfy the in-

\(^{66}\) Id. at 487-88.  
\(^{67}\) Id. at 488.  
\(^{68}\) Id.  
\(^{69}\) Id.  
\(^{70}\) See id. at 492-93.  
\(^{71}\) See supra notes 51-52 and accompanying text.
vestment contract test may still be a security if it falls under one of the other specific statutory terms.

The Seventh Circuit then addressed RBC's contention that fixed interest payments cannot satisfy the profits element of the Howey test. As discussed earlier, the Howey test is the test generally employed in order to determine whether an instrument constitutes a security. In particular, Howey requires an expectation of profits to be derived from the efforts of others. In Forman, the Supreme Court defined profits as appreciation or a proportionate share in earnings. Various Supreme Court and Seventh Circuit decisions strongly indicated that fixed returns do not satisfy the Forman definition. For example, in Marine Bank v. Weaver, the Supreme Court, in finding that the certificate of deposit at issue was not a security, emphasized the fact that the instrument paid a fixed rate of return not based upon the profitability of the enterprise. Additionally, in American Fletcher Mortgage Co. v. United States Steel Credit Corp., the Seventh Circuit found that the loan participation agreement at issue did not lead to an expectation of profits because it entitled the holder to a "fixed return independent of the underlying project." In view of its examination of the law, the Seventh Circuit concluded that the instruments bearing fixed rates of return do not satisfy the profits requirement of Howey.

Although the Seventh Circuit determined that fixed returns do not satisfy the profits requirement of Howey, the court went on to question the wisdom of excluding fixed interest payments from the definition of profits. The court pointed out that it apparently was Congress' intent, in including the broad concept of an investment contract in the definition of a security, to "prevent imaginative promoters from avoiding regulation by inventing nonconventional instruments." The court warned that, by giving the term "profits" an inflexible definition, courts may be frustrating Congress' goals. The court stated that in the future it may reconsider its interpretation of the Supreme Court's analysis of the Howey test.

72. See supra notes 48-52 and accompanying text.
73. See supra note 50 and accompanying text.
74. 421 U.S. at 852.
75. 745 F.2d at 490.
77. 635 F.2d 1247, 1254 (7th Cir. 1980), cert. denied, 451 U.S. 911 (1981).
78. 745 F.2d at 491.
ARBORITION OF FEDERAL, STATE AND COMMON LAW SECURITIES CLAIMS

Many brokerage companies include broadly worded arbitration clauses in contracts governing their individual investment accounts. These arbitration clauses traditionally provide that any dispute arising out of the contract must be settled by arbitration. Under the Federal Arbitration Act, federal courts are required to enforce arbitration agreements unless they are otherwise invalid in law or equity. However, courts have created exceptions to their duty to compel arbitration under the Act in certain situations involving protective federal legislation. In particular, various circuits have found that, with respect to claims arising out of contracts governing investment trading accounts, federal courts are not required to compel arbitration of state law claims where such claims are inextricably linked with federal securities claims. Other circuits have found that courts may stay arbitration of state law claims until after judicial resolution of the federal claims. During its 1984-85 term, the Seventh Circuit decided Pierson v. Dean, Witter, Reynolds, Inc., in which it reaffirmed its acceptance of this latter view. Soon thereafter, however, the Supreme Court decided Dean, Witter, Reynolds, Inc. v. Byrd, and held that federal courts must compel arbitration of any arbitrable claims and may not stay such arbitration until after judicial resolution of any nonarbitrable claims. After Byrd, two questions remain open;

80. See Wilko v. Swan, 346 U.S. 427 (1953) (arbitration agreements are void with respect to claims arising under § 12(2) of the Securities Act of 1933); Applied Digital Technology, Inc. v. Continental Casualty Co., 576 F.2d 116 (7th Cir. 1978) (claims arising under the antitrust laws are inappropriate claims for arbitration); Allegaert v. Perot, 548 F.2d 432 (2d Cir.), cert. denied, 432 U.S. 910 (1977) (claims under the Bankruptcy Act and the antifraud provisions of the Securities Exchange Act of 1934 are inappropriate claims for arbitration); Beckman Instruments, Inc. v. Technical Dev. Corp., 433 F.2d 55, 63 (7th Cir. 1970), cert. denied, 401 U.S. 976 (1971) (claims arising under the patent laws are inappropriate for arbitration); Breyer v. First Nat'l Monetary Corp., 548 F. Supp. 955, 961 (D.N.J. 1982) (arbitration is unsuitable for claims under the Commodity Exchange Act except under the narrow circumstances delineated in 7 U.S.C. § 7a(11)).

81. The Fifth and Eleventh Circuits have held that, where the state law claims are inextricably intertwined, the federal court may in its discretion deny arbitration as to the state claims and try all the claims together. See Belke v. Merrill Lynch, Pierce, Fenner & Smith, 693 F.2d 1023 (11th Cir. 1982); Miley v. Oppenheimer & Co., 637 F.2d 318, 334-37 (5th Cir. 1981); see also Cunningham v. Dean, Witter, Reynolds, Inc., 550 F. Supp. 578 (E.D. Cal. 1982).

82. The Sixth, Seventh and Eighth Circuits have found that the Federal Arbitration Act divests them of any discretion in compelling arbitration of the state claims but may stay arbitration until after the judicial resolution of the federal securities claim. Surman v. Merrill Lynch, Pierce, Fenner & Smith, 733 F.2d 59 (8th Cir. 1984); Liskey v. Oppenheimer & Co., 717 F.2d 314 (6th Cir. 1983) Dickinson v. Heinold Sec., Inc., 661 F.2d 638 (7th Cir. 1981).

83. 742 F.2d 334 (7th Cir. 1984).
whether federal securities claims are arbitrable and if so, whether once arbitrated, are subject to collateral estoppel effect.

In 1977, the Piersons opened a nondiscretionary margin trading account with Dean, Witter, Reynolds, Inc. (Dean Witter). The Piersons signed a contract which provided, in part, for the arbitration of any controversy arising out of or related to the contract. Subsequently, the Piersons brought suit in federal court alleging Dean Witter violated Rule 10b-5 and committed various common law offenses including breach of fiduciary duty, negligence, gross negligence and fraud. Dean Witter moved to dismiss the common law claims or, in the alternative, to stay those claims for arbitration. The district court denied the motion. The Seventh Circuit reversed, holding that the district court was required to compel arbitration of the state law claims but may stay such arbitration until after judicial resolution of the federal claims.85

As the Pierson case was developing, the Court of Appeals for the Ninth Circuit confronted essentially the same issue in Byrd. The district court refused to compel arbitration of the state law claims and the Ninth Circuit affirmed.86 The Supreme Court granted certiorari and reversed. The Supreme Court held that federal courts are required to compel arbitration of arbitrable claims and, further, may not stay arbitration of those claims until after judicial resolution of non-arbitrable claims. Thus, Byrd effectively overruled the Seventh Circuit’s decision in Pierson. In deciding Pierson, the Seventh Circuit had assumed, without inquiry, that the plaintiff’s federal securities claim was not subject to arbitration.87 However, the Supreme Court in Byrd pointed out that it has never held that agreements to arbitrate claims arising under Rule 10b-5 are void.88 Although the Supreme Court refused to decide the issue, Justice White, in his concurring opinion, indicated that such claims may be subject to arbitration.

Justice White acknowledged that the Supreme Court held, in Wilko v. Swan,89 that agreements to arbitrate under section 12(2) of the 1933 Act are not enforcible. However, Justice White found that the provisions of the 1933 Act relied upon by the Court in Wilko were significantly distinguished from the analogous provisions contained in the 1934 Act.90

85. 742 F.2d at 340.
86. Dean, Witter, Reynolds, Inc. v. Byrd, 726 F.2d 552 (9th Cir. 1982).
87. 742 F.2d at 338 (the court stated “the Rule 10b-5 claim is concededly not arbitrable”).
88. 105 S. Ct. at 1240 n.1.
89. 346 U.S. 427 (1953).
90. Byrd, 105 S. Ct. at 1244-45. Justice White pointed out that the Wilko Court, in holding that claims arising under § 12(2) of the Securities Act of 1933 were non-arbitrable, reasoned that § 14 of the 1933 Act provides that any “stipulation” waiving compliance with any “provision” of the
Therefore, Justice White cautioned, the Wilko doctrine may not be automatically transplanted to claims arising under the 1934 Act. Justice White emphasized that the issue was still an open one.91

In Byrd, the plaintiffs advanced two justifications to the Court supporting the Ninth Circuit's refusal to compel arbitration of the pendent state claims. First, they argued that arbitration of the state law claims would frustrate one of the two goals of the Arbitration Act—to encourage efficient and speedy dispute resolution—because it would result in bifurcated proceedings. The Supreme Court responded that the other goal of the Arbitration Act—enforcement of private agreements to arbitrate—was preeminent and therefore the conflict between the goals must be resolved in favor of the latter.

Secondly, the plaintiffs argued that arbitration of the state law claims would threaten the federal courts' exclusive jurisdiction over federal securities issues because the arbitration proceeding could have collateral estoppel effect as to the subsequent judicial proceeding involving resolution of the federal securities claim. The Court concluded that it was far from certain that arbitration proceedings have preclusive effect as to "non-arbitrable federal claims," and indicated that they may not have such effect.92 The Court found that in framing preclusive rules in this context, the courts will be required to take into account the federal interests warranting protection.93 Thus, the Court found that the federal interests at stake are adequately protected without joining proceedings or staying arbitration in contravention of the purposes of the the Federal Arbitration Act.

Thus, after Byrd, it remains to be resolved whether federal securities claims are arbitrable and, if so, to what extent they may be "retried" in a

Securities Act is void. Section 12(2) of the Act expressly creates a private right of action which is enforceable in any court. The Wilko Court determined that this right to select the forum in which to litigate a § 12(2) claim constituted a "provision" of the Act, and as such, could not be waived.

Although § 29 of the 1934 Act is equivalent to § 14 of the 1933 Act, Justice White did not believe that the reasoning of Wilko could be "mechanically transplanted" to claims arising under § 10(b) of the 1934 Act. Jurisdiction under the 1934 Act is narrower than jurisdiction under the 1933 Act, being restricted to federal courts. Moreover, unlike § 12(2), there is no express private right of action under § 10(b). Thus, the conclusion that the right to select the forum in which to litigate a Rule 10b-5 claim constitutes a "provision" of the 1934 Act which cannot be waived is weaker than for § 12(2). See also Scherk v. Alberto-Culver Co., 417 U.S. 506 (1974).

91. Prior to Byrd many lower courts held that claims arising under § 10(b) of the 1934 Act were not arbitrable. See Byrd, 105 S. Ct. 1238, 1240 n.1.

92. Id. at 1238. The Court noted that in McDonald v. City of West Branch, 466 U.S. 284 (1984), it held that unappealed arbitration awards do not have collateral estoppel effect as to § 1983 actions. The Court found that arbitration proceedings were not adequate substitutes for judicial proceedings with respect to protecting the federal statutory and constitutional rights that § 1983 was designed to protect.

93. 105 S. Ct. at 1244.
federal court.\textsuperscript{94} In interpreting \textit{Byrd}, some courts have held that claims arising under the 1934 Act are arbitrable.\textsuperscript{95} However, it does not appear that the issue of whether such arbitrable claims are subject to collateral estoppel effect has been litigated as of yet. With respect to this latter issue, it may be important to note that giving collateral estoppel effect to such arbitrable claims may controvert Congress' intent in enacting the Securities Acts. In drafting the Securities Acts, Congress was aware of the fact that corporations as well as securities professionals stand on a different footing than the ordinary investor in their respective abilities to accurately evaluate a particular security.\textsuperscript{96} One of Congress' purposes was to equalize their respective positions. If courts conclude that claims arising under Rule 10b-5 are arbitrable, and once arbitrated are subject to collateral estoppel effect, then the investor will waive the extra protections the Securities Acts were designed to give him merely by signing a contract containing an arbitration clause.

\textbf{Brokers' Liability Under The Illinois Law of Negligent Misrepresentation}

Many investors rely upon the advice of their brokers in making investment decisions. Often, brokers, not knowing their clients' financial situations or investment goals, advise clients to purchase stock which is inappropriate for them. For instance, the broker may recommend stock which is overly speculative given the client's ability to absorb the potential loss. Many investors have lost fortunes because they were given poor investment advice by their brokers. The problem may arise from, or at least is exacerbated by the fact that the broker, who provides investment advice, has an inherent conflict of interest because he receives his commission on the sales that he makes as opposed to the profit he makes for his client.

Various federal rules and statutes have been promulgated in order to

\textsuperscript{94} The Court's strong stance on arbitration in \textit{Byrd} may indicate that it will not accept the circuit courts' holdings as to the enforceability of arbitration agreements in other contexts. See cases cited \textit{supra} note 80. For example, the permeation doctrine, which is applied by the Seventh Circuit in antitrust suits, could come under attack: The "permeation doctrine" provides that if the antitrust issues permeate the entire case, then the district court should proceed with the antitrust issues before submitting the arbitrable claims to the arbitrator. \textit{See} Digital Technology, Inc. \textit{v.} Continental Casualty Co., 576 F.2d 116, 117 (7th Cir. 1978).

\textsuperscript{95} \textit{See} Finn \textit{v.} Davis, 610 F. Supp. 1079 (S.D. Fla. 1985). \textit{See also} Morgan, Olmstead, Kennedy \& Gardner \textit{v.} U.S. Trust Co. of N.Y., 608 F. Supp. 1561 (S.D.N.Y. 1985) (holding that claims arising under § 10(b) between members of the New York Stock Exchange were arbitrable). \textit{But see} Rojas Cancanon \textit{v.} Smith Barney, Harris, Upham \& Co., Inc., 612 F. Supp. 996 (S.D. Fla. 1985) (finding that it was bound by prior decisions of the Fifth and Eleventh Circuits, the court held that the federal claims were not arbitrable).

\textsuperscript{96} \textit{See} Wilko, 346 U.S. at 435 (1953).
regulate brokers' conduct in rendering investment advice. In particular, the National Association of Securities Dealers and the New York and American Stock Exchanges have enacted rules (denoted "suitability rules") which require registered securities broker-dealers to recommend only those investments which are suitable to the investor's financial situation and investment goals. The broker-dealer is required to conduct a reasonable inquiry to determine the investor's financial situation and investment goals.

Although these rules may be effective in improving the quality of investment advice given by brokers in general, until recently, they were of little significance to the injured investor. The rules do not expressly provide a private right of action for the injured investor and it is unlikely that a court would find that an implied right of action exists. Moreover, even if the rules could be utilized as a standard for finding fraud under Rule 10b-5, in order to recover, a plaintiff must establish that the broker-dealer intentionally or recklessly recommended unsuitable investments. Thus, these rules may provide little solace for the investor who loses his fortune due to the negligent conduct of his broker. However, the Seventh Circuit in Zurad v. Lehman Brothers Kuhn Loeb, Inc. gave more significance to these rules by holding that an injured investor can recover against a broker who negligently fails to conform with a standard of conduct similar to that imposed by the suitability rules under a theory of negligent misrepresentation.

Zurad was a fifty-four year old postal worker. In 1978, she opened a non-discretionary trading account with Lehman Brothers. Curry, who worked for Lehman, became her broker. Prior to opening the account with Lehman, Zurad had gained some experience in the stock market.


99. Although in Buttrey v. Merrill Lynch, Pierce, Fenner & Smith, 410 F.2d 135 (7th Cir.), cert. denied, 396 U.S. 838 (1969), the Seventh Circuit held that there was an implied right of action under the suitability rules, after the Supreme Court's decision in Cort v. Ash, 422 U.S. 66 (1975) and Touche Ross & Co. v. Redington, 442 U.S. 560 (1979), it is doubtful that the Seventh Circuit would find that such a cause of action exists today. See Baker & Lawrence, supra note 97, at 287-302 (explaining why it is unlikely that a court would find that an implied right of action under the suitability rules exists today).


101. 757 F.2d 129 (7th Cir. 1985).
She had invested in a mutual fund, traded in options and traded on margin. She had not always followed the advice of her brokers and had sustained losses of $15,000. Additionally, she was able to read stock quotations in the newspaper but did not normally read the financial section. Zurad told Curry that she had approximately $100,000 to invest, and that her investment goals included income production, financial growth and recoupment of losses.

During the period of time in which Curry acted as Zurad’s broker, news of a potential acquisition of Heller Co. by Midland Bank, Ltd., of London was widely publicized. Consequently, the price of Heller stock rose dramatically and trading was suspended on two occasions. Curry recommended to Zurad that she purchase 2000 shares of Heller stock. Zurad was unaware of the news stories, the recent increase in price or of the suspension of trading, and Curry did not inform her of them. Zurad purchased 5000 shares on margin. The merger fell through and the stock price plummeted.

Zurad brought suit against Curry and Lehman to recover her losses which exceeded $75,000. She claimed that Curry violated the suitability rules. Additionally, she alleged that Curry misrepresented that he had inside information concerning the merger, in violation of 10b-5, and that Curry’s failure to tell her of the recent increase in the price of Heller stock or of the suspension of trading constituted violations of 10b-5 and the Illinois law of negligent misrepresentation.

The district court found for the defendants on all four charges. Initially, the court determined that there was no implied right of action under the suitability rules. This issue was not brought before the Seventh Circuit on appeal. With respect to Zurad’s claim that Curry misrepresented that he had inside information concerning the merger, in violation of 10b-5, and that Curry’s failure to tell her of the recent increase in the price of Heller stock or of the suspension of trading constituted violations of 10b-5 and the Illinois law of negligent misrepresentation. Additionally, the district court held that Zurad, as a recipient of material nonpublic information, could not recover under this claim because she was in pari delicto.

Further, with respect to Curry’s failure to inform Zurad of the recent surge in the price of Heller stock or suspension of trading, the district court found that Zurad had not established scienter and therefore found no violation of Rule 10b-5. And lastly, the district court found that Curry had not negligently misrepresented the degree of speculation involved in the purchase of Heller stock because he had advised Zurad
against investing all her assets and indicated that there was a possibility that the merger might not necessarily occur.

The Seventh Circuit did not resolve Zurad's claim that Curry misrepresented that he had inside information in violation of Rule 10b-5. However, the court discussed the district court's determination that Zurad could not have reasonably relied upon such representation. The Seventh Circuit concluded that the district court was clearly erroneous in finding that Zurad knew or should have known of the news stories. The court emphasized Zurad's limited experience in the securities markets, her employment as a mail sorter, her infrequent reading of the newspaper's financial section and the timing of the publications which preceded Curry's recommendation of Heller stock. The Seventh Circuit did not decide the *in pari delicto* defense, however, the Supreme Court has subsequently held that the defense of *in pari delicto* is not available to a tipper.102

The Seventh Circuit then upheld the district court's finding that Curry's failure to tell Zurad of the recent price surge of Heller stock and the suspension of trading did not violate Rule 10b-5 in that Zurad had not established scienter. However, the Seventh Circuit found that Curry negligently misrepresented the degree of speculation involved in the purchase of Heller stock and thus was liable to Zurad under Illinois law.103

The essential elements of negligent misrepresentation are a duty owed, a breach of that duty and injury proximately resulting therefrom.104 The Seventh Circuit determined that Curry, in rendering investment advice to Zurad, had a duty to exercise reasonable care or competence in obtaining or communicating information intended to guide her in her investment decisions. The court concluded that the information regarding the recent surge in price and the suspension of trading was highly significant with respect to the degree of speculation involved, and therefore, the omission of this information amounted to negligent misrepresentation.

Interestingly, in finding that Curry violated Illinois negligent misrepresentation law, the court effectively imposed a duty upon Curry, and all brokers who provide investment advice, to disclose those factors

103. See Lyons v. Christ Episcopal Church, 71 Ill. App. 3d 257, 389 N.E.2d 623 (1979) (the Illinois court held that a real estate agent was liable to her client for negligently misrepresenting the condition of the sale property).
104. 757 F.2d at 134. The court based this duty on the RESTATEMENT (SECOND) OF TORTS, § 552 (1965), which was cited with approval in Citizens Sav. and Loan Ass'n v. Fischer, 67 Ill. App. 2d 315, 325, 214 N.E.2d 612, 617 (1966).
which make a particular investment "unsuitable" for that investor. Although the Seventh Circuit did not expressly refer to the suitability rules, the court emphasized the factors which made the investment unsuitable to Zurad. These factors include the probability that the price of Heller stock would fall to its pre-merger publicity levels if the merger did not go through, the extent of Zurad's savings that Curry recommended she invest, the extent of her savings she in fact decided to invest and Zurad's lack of familiarity with the stock market.

By imposing a duty on brokers to disclose the factors which make an investment unsuitable, the Seventh Circuit effectively imposed a duty on brokers to conduct an investigation to determine the financial situations and investment goals of their customers. These are essentially the same duties imposed by the suitability rules. Thus, after Zurad, a broker may be liable for his clients' losses where such broker has negligently failed to conform with the suitability rules in rendering investment advice. The Seventh Circuit's holding in Zurad is consistent with a line of cases which have held either that a violation of the suitability rules is per se negligence, or that the rules provide a standard for negligence.  

THE MAIL FRAUD STATUTE AND THE COMMODITIES FUTURES TRADER

The mail fraud statute has become a device with which the government stamps out generic fraud. Not only is it utilized to deal with newly conceived forms of fraud for which there is no "brand name" legislation, it is utilized where brand name legislation has been enacted but is somehow deficient. In United States v. Dial, decided by the Seventh Circuit during its 1984-85 term, the court affirmed the criminal con-

105. See Baker & Lawrence, supra note 98, at 306.
108. See supra note 107. The government may sue under the mail fraud statute in order to obtain a more severe penalty than allowable under a statute enacted to deal with the particular fraudulent practice, provided, of course, that the particularized legislation does not preempt the mail fraud statute. See United States v. Brien, 617 F.2d 299, 310 (1st Cir.), cert. denied sub nom. Labus v. United States 446 U.S. 919 (1980). Additionally, the government may sue under the mail fraud statute when it feels that the language of the particularized legislation is ambiguous and thus conviction under such legislation is less certain. See United States v. Dial, 757 F.2d 163, 167 (7th Cir.), cert. denied, 106 S. Ct. 116 (1985). Finally, the mail fraud statute is often joined with claims arising
viction of a commodities futures trader until the mail and wire fraud statutes. At the time the suit was initiated, an express cause of action for the offense existed under the Commodities Futures Trading Act. This note will examine the appropriateness of permitting the government to sue under the mail fraud statute in the case where specialized legislation has already been enacted. Further, it will explore the dicta of the Dial case indicating the Seventh Circuit’s willingness to broadly construe the mail and wire fraud statutes. And lastly, it will examine the implications of the Dial dicta on securities and commodities laws.

Dial was an experienced silver futures trader and manager of a branch office of the Clayton Brokerage Company (Clayton). Defendant Salmon was Clayton’s president. The International Monetary Corporation (IMC) was a large foreign investment group.

On the weekend of November 10, 1978, IMC issued Clayton a check for $25 million in order to open a discretionary futures trading account. On that same weekend, Dial solicited his regular customers in order to create a large block order for February silver futures contracts. Thereafter, the defendants engaged in an elaborate scheme whereby they purchased February silver futures contracts for their own account, then drove the prices higher by placing the block order for the same on behalf of their regular customers and then larger orders on behalf of IMC. At some point during the same day, the defendants learned that the IMC check would not clear. Approximately a week or so later, the defendants sold the contracts, first selling those in their own account, then those of their regular customers and lastly those of IMC. All of the defendants’ customers made a profit and the IMC account was liquidated at a profit.

In perpetrating their scheme, Dial and Salmon failed to protect Clayton by making margin deposits in their personal trading accounts. Because futures exchanges require brokerage firms to maintain deposits with the exchange to cover trading losses, brokerage firms in turn require under the Securities and Comodities Acts. See 3 L. Loss, Securities Regulation 1430 (2d ed. 1961).

109. 757 P.2d 163 (7th Cir. 1985).
110. 18 U.S.C. §§ 1341, 1343 (1982). The language of the wire fraud statute is very similar to that of the mail fraud statute and courts have generally interpreted the statutes as prohibiting the same types of conduct. See H. Friedman, Securities and Commodities Enforcement 146 (1981).
111. See infra note 115 and accompanying text.
112. The check given by IMC was not certified. Communications with the bank upon which the check was drawn made it increasingly likely that the check would not clear. At some point during the day, Dial and Salmon learned these facts. It was unclear whether they learned of the facts prior to the completion of their scheme.
similar deposits from customers. Absent such margin deposits, the brokerage firm itself must absorb any losses on customer trades. In the Dial scheme, Dial and Salmon deleted their trading accounts from Clayton's computerized margin program thereby escaping Clayton's margin requirements. Similarly, because IMC's check did not clear, IMC had no margin deposited with Clayton. Dial and Salmon concealed these facts from other Clayton agents.

The excessive trading in February silver futures contracts caught the attention of the Board of Trade and the Commodities Futures Trading Commission. After an investigation, the United States government brought an action for mail and wire fraud against the defendants. The defendants were found guilty by a jury. The Seventh Circuit affirmed their convictions.

The Seventh Circuit, in affirming the convictions, concluded that the defendants had defrauded their customers. The court reasoned that Dial, as a fiduciary, implicitly represented to his customers that he would try to get them the best possible price. By intending to place his order ahead of his customers, and by failing to disclose that fact, Dial misled his customers and personally profited from them. The court also found that the defendants had defrauded Clayton. By trading their personal accounts and the IMC account without margin, the defendants shifted the risk of losses to Clayton. The defendants' failure to disclose the risk amounted to fraud.

The government did not charge the defendants with violations of the Commodities Futures Trading Act (CFTA). Although the CFTA imposes criminal liability under sections 4(b) and 9(b) on commodities dealers who defraud or attempt to defraud their customers, the Seventh Circuit found that it was proper to permit the government to sue under the mail and wire fraud statutes. First, the court determined that coverage under the CFTA was uncertain. And second, it found that the CFTA does not supersede the mail and wire fraud statutes.

Although commentators have suggested that coverage under the CFTA is uncertain because the Act is ambiguous as to who can be held liable, courts do not appear to have found difficulty in finding that

113. See generally 1 P. Johnson, Commodities Regulation § 1.10 (1982).
114. The penalty for a single violation of the CFTA is more severe than that under the mail and wire fraud statutes. See 7 U.S.C. § 13(b) (1982) (not more than $500,000 or imprisonment for five years under the CFTA); 18 U.S.C. § 1341 (1982) (not more than $1000 or imprisonment for five years under the mail fraud statute).
115. 7 U.S.C. §§ 6b(A), 13(b) (1982).
116. See 1 Bromberg & Lowenfels, Securities Fraud & Commodities Fraud § 4.6 (452) (Supp. 1984).
commodities dealers may be subject to liability under the CFTA.\textsuperscript{117} Thus, it is unlikely that there would be uncertainty as to whether Dial or Salmon are covered under the Act. Nevertheless, it appears well settled that the Act does not supersede the mail and wire fraud statutes.\textsuperscript{118} Thus, there was no legal impediment to the imposition of criminal liability under the mail and wire statutes in the Dial case.

However, the Dial case is a good illustration of why it may be unwise to permit parties to sue under the mail and wire fraud statutes where specialized legislation has been enacted. As it will be demonstrated below, in Dial, the Seventh Circuit indicated a willingness to broadly construe the statutes. If the Seventh Circuit interprets the statutes as broadly as Dial indicates it will, then the proof requirements under the mail and wire fraud statutes may become less stringent than under Rule 10b-5 or other specialized legislation. Consequently, the statute may be employed to plug loopholes in legislation which Congress did not intend to be plugged.\textsuperscript{119}

Although the Seventh Circuit's decision in Dial was fairly straightforward, in dicta the Seventh Circuit indicated a willingness to broadly interpret the mail and wire fraud statutes. First, in the Dial case, none of the alleged victims actually suffered financial loss. Yet the Seventh Circuit concluded that the injury requirement was satisfied. The court found: (1) if the market had not been strong, then the price of silver futures contracts would have collapsed; (2) if the defendants, in perpetrating their scheme, had placed their customers' orders before their own, then their customers would have made more money; (3) the risk of loss was shifted to Clayton and this was itself an injury;\textsuperscript{120} (4) the prac-


\textsuperscript{118} United States v. Brien, 617 F.2d 299, 309-11 (1st Cir.), cert. denied sub nom. Labus v. United States, 446 U.S. 919 (1980); United States v. Shareef, 634 F.2d 679 (2d Cir. 1980); Bishop v. Commodity Exch., Inc., 564 F. Supp. 1557 (S.D.N.Y. 1983); United States v. Abrahams, 493 F. Supp. 296 (S.D.N.Y. 1980). These courts recognized that Congress' intent in enacting the CFTA was to vest exclusive jurisdiction in the Commodities Futures Trading Commission over the regulation of the Commodities Acts. However, the Senate Committee made it clear that the CFTA did not prevent states from enforcing their antifraud statutes. As a corollary, the courts have found that the mail fraud statute is not preempted. See Johnson, The Commodity Futures Trading Commission Act: Preemption as Public Policy, 29 VAND. L. REV. 1, 20 (citing S. REP. No. 73, 94th Cong., 1st Sess. (1975)).

\textsuperscript{119} The court's willingness to interpret the mail and wire fraud statutes broadly also has implications with respect to liability under the Racketeer Influenced and Corrupt Organizations Act (RICO). 18 U.S.C. §§ 1961-68 (1982). The mail and wire fraud statutes contain two of the underlying offenses which may give rise to RICO liability. See id. § 1961. A civil plaintiff may obtain treble damages under RICO. Id. at § 1964(c). Thus, if the Seventh Circuit intends to interpret the mail and wire fraud statutes broadly, then RICO may give rise to enormous recoveries in cases where the Securities Acts would provide no recovery.

\textsuperscript{120} The court determined that the risk of injury satisfies the injury requirement. The court analogized to an employee who takes money from his employer and replaces it before it is missed.
tice undermined the confidence in the market and thereby threatened to destroy the benefits which the market bestows on society. \(^{121}\)

Injury has long been considered an essential element of fraud. \(^{122}\) However, even prior to its decision in *Dial*, the Seventh Circuit had substantially eroded the injury requirement of the mail and wire fraud statutes. \(^{123}\) For example, the Seventh Circuit has found that the injury requirement is satisfied where an employee has deprived his employer of loyal and faithful service. \(^{124}\) The Seventh Circuit’s relaxed reading of the injury requirement has been criticized by commentators. \(^{125}\) *Dial* illustrates that the Seventh Circuit intends to continue treating the injury requirement in a relaxed manner.

And second, the court suggested that the defendants not only defrauded their customers and Clayton, but they defrauded the participants in the commodities futures market as well. \(^{126}\) The court found it significant that Dial and Salmon traded their personal and IMC accounts without margin. The court concluded that Dial and Salmon, by trading without margin, created a misleading signal to the market participants, and thereby defrauded them. \(^{127}\)

The fact that the employer does not suffer financial loss is irrelevant; the employee is still guilty of embezzlement. *See* United States v. Bailey, 734 F.2d 296, 303-04 (7th Cir.), *cert. denied*, 105 S. Ct. 327 (1984). However, unlike mail fraud, the elements of embezzlement do not include injury. Thus, risk of injury may not be sufficient to establish injury under the mail fraud statutes. In *Dial*, the court did not rely on the theory of “fiduciary fraud” which has been developed by other Seventh Circuit cases. The fiduciary fraud theory contemplates that an employee owes a duty of loyalty and honesty to his employer. The deprivation of faithful service is an injury within the ambit of the mail fraud statute. *See* United States v. Bryza, 522 F.2d 414, 421-23 (7th Cir. 1975), *cert. denied*, 426 U.S. 912 (1976). The fiduciary fraud theory has been criticized by commentators. *See* Moreno, *supra* note 107.

121. *See* 757 F.2d at 165-66 (the court discusses the benefits that commodity futures trading bestows on society).


123. In *United States v. Bryza*, 522 F.2d 414 (7th Cir. 1975), *cert. denied*, 426 U.S. 912 (1976), the Seventh Circuit found that intangible harm can satisfy the injury requirement under the mail fraud statute, and therefore the deprivation of an employer’s right to the honest and faithful services of its employee was sufficient injury. *See generally* Moreno, *supra* note 107, at 65-70.

124. *Bryza*, 522 F.2d 414; *see also* supra note 123.


126. 757 F.2d at 169.

127. The court reasoned that the defendants’ purchases of February silver futures contracts indicated to market participants that some investors were predicting that the market price for such contracts would rise. However, the defendants purchased the contracts not because they predicted, based upon market conditions, that the market price would rise, but because they knew that through their scheme they would be able to manipulate the price. Thus, the defendants’ trading misled market participants. *Id.* at 169-70.
The difficulty with finding fraud with respect to the market participants is the lack of any duty owed by the defendants to disclose the fact that they were trading without margin or to refrain from doing so.\textsuperscript{128} Even under Rule 10b-5, which has generally been considered a flexible antifraud provision, courts have required some element of a duty owed and a breach of that duty, or in any case, some element of deceit.\textsuperscript{129}

Thus, the \textit{Dial} case illustrates that the mail and wire fraud statutes still play a vital role in securities and commodities laws. Further, and more importantly, even though the Seventh Circuit's affirmation of the mail and wire fraud convictions in \textit{Dial} is quite proper and not in the least alarming, in dicta the court indicated that it intends to construe the mail and wire fraud statutes broadly. The court's broad reading of the statutes leaves open the possibility that the statutes may inadvertently be utilized to plug loopholes in Rule 10b-5 and other specialized legislation. It is questionable whether Congress intended the mail and wire fraud statutes to be used in this manner.

**CONCLUSION**

During its 1984-85 term, the Seventh Circuit decided a variety of securities cases. The decisions indicate that the court is not willing to restrict protections afforded to investors. For example, the court refused to find that an investor's failure to investigate was unreasonable under Rule 10b-5 even though the investor was obligated by law to conduct such an investigation. Additionally, the court found that instruments qualifying as notes do not also have to qualify as investment contracts in order to constitute securities.

The court also demonstrated a willingness to extend protections for investors through means other than the Securities Acts. For instance, the court found that a broker, who renders investment advice to his client, is liable to the client under the Illinois law of negligent misrepresentation when that broker fails to inform the client of the factors which make a particular investment unsuitable for the client. Additionally, the

\textsuperscript{128} Arguably, the fact that brokerage firms are required to maintain certain margin levels with the Commodities Exchanges, imposes some kind of a duty on commodities traders to disclose whether they are trading without margin because other traders are entitled to rely on compliance with margin requirements. \textit{See infra} note 113 and accompanying text.

\textsuperscript{129} \textit{See In re Cady, Roberts & Co.,} 40 S.E.C. 907, 911-12 (1961) (in determining whether the defendant was liable under Rule 10b-5, the Commission first found it necessary to determine whether the defendant was under a duty to disclose the information); Chiarella v. United States, 445 U.S. 222, 228-35 (1979) (following \textit{Cady, Roberts}, the Supreme Court held that the defendant was not liable under Rule 10b-5 for trading on inside information because the defendant was under no duty to disclose the information).
court indicated a willingness to interpret the mail and wire fraud statutes loosely and thereby created a possibility that the statutes will provide a remedy where the Securities Acts would not.

On the other hand, the decisions indicate an unwillingness to extend the application of the Securities Acts beyond their intended proscriptions. The court refused to vary the standards under FED. R. CIV. P. 60(b) for reopening judgments in securities cases. The court found that Congress did not intend to alter the rules of civil procedure when it enacted the Securities Acts. Further, the court demonstrated that it continues to consider the commercial nature of an instrument to be essential to the determination of whether the instrument constitutes a security.

Two of the Seventh Circuit's well-settled rules of law which it reaffirmed this term were subsequently rejected by the Supreme Court. The Supreme Court rejected the sale of business doctrine. Additionally, the Court held that federal courts may not stay arbitration of any arbitrable claims until after judicial resolution of nonarbitrable claims.