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SECURITIES LAW
ROBERT E. CURLEY*
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During the 1976-1977 term,¹ the United States Court of Appeals for the Seventh Circuit remained in the forefront of developments in securities law. This article will focus on three areas in which the Seventh Circuit handed down significant securities decisions. These are: (1) the definitions of "security," with particular emphasis upon the Seventh Circuit's decision in Daniel v. International Brotherhood of Teamsters;² (2) the development of a standard of "recklessness" sufficient to satisfy the requirement of scienter under the anti-fraud provisions of the securities acts imposed by the Supreme Court's decision in Ernst & Ernst v. Hochfelder;³ and (3) the appropriate measure of damages in merger cases involving a violation of section 14(a) of the Securities Exchange Act of 1934, as set forth in Mills v. Electric Auto-Lite Co.⁴ In addition, this article will discuss various securities cases from the Seventh Circuit which do not fall into the above three areas, but which nonetheless are worthy of note.

THE DEFINITION OF "SECURITY"
Daniel v. International Brotherhood of Teamsters

Perhaps the most far-reaching decision of the Seventh Circuit in the securities field during the 1976-1977 term was Daniel v. International Brotherhood of Teamsters,⁵ in which the court held that an employee's interest in a pension plan was a "security" for purposes of the securities acts, and thus subject to the acts' anti-fraud provisions.⁶

The facts of Daniel are relatively straightforward. Plaintiff was a member of Union Local 705 of the International Brotherhood of Teamsters. He had been an employee of Local 705 since April of 1950, and had worked...

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¹ This article will discuss decisions of the Court of Appeals for the Seventh Circuit which were published between the summer of 1976 and the fall of 1977.
² 561 F.2d 1223 (7th Cir. 1977) cert. granted, 46 U.S.L.W. 3526 (U.S. Feb. 21, 1978) (No. 77-753).
⁵ 561 F.2d 1223 (7th Cir. 1977).
continuously as a truck driver with Local 705 from April 1950, to November 1973, except for a brief four-month involuntary lay-off from December 1960, until April 1961. 7 Plaintiff learned of Local 705's pension fund in 1955, and considered the pension fund to be a material factor in his continuing employment with Local 705 "covered employers," i.e., employers who, pursuant to labor contracts negotiated by the Teamsters, make set payments into pension funds for Teamster members in partial consideration for services performed by those union members in the course of their employment and in lieu of wages. 8 None of the communications plaintiff received over the course of his 22-year service with Local 705 covered employers dispelled his expectation of receiving retirement benefits from the pension fund. 9 After his retirement, plaintiff was informed that the four-month temporary lay-off in 1960-1961 rendered him ineligible for pension benefits under the "break in service" rule contained in the plan. 10 The plaintiff then brought an action against Local 705, the International Brotherhood of Teamsters, and certain other Teamster union locals with pension funds on behalf of all members of all affiliated locals of the Teamsters who had "purchased and acquired an interest in a Teamsters' pension fund." 11

In his complaint, plaintiff asserted that defendants had both misrepresented and omitted material facts concerning the value of a union member's interest in the pension fund. Specifically, the complaint alleged that statements concerning the length and continuity provisions of the vesting requirements of the plan were misleading, and constituted material misrepresentations. 12 As concerns the material omissions, the plaintiff's complaint alleged they consisted of (1) failure to inform members that unless the length and continuity requirements of the vesting provisions were satisfied they would receive no benefits, and previous employer-paid contributions would be forfeited; (2) failure to disclose the arbitrary nature of the plan's actuarial basis; (3) failure to disclose the actuarial likelihood that a union member would receive any pension benefits whatsoever; and (4) failure to state that defendants had arbitrarily diverted pension funds for the benefit of persons other than members of the union locals. 13

7. 561 F.2d at 1227.
8. Id.
9. Id.
10. The Local 705 pension fund had a twenty year vesting period. If a member did not meet this length of service requirement, his entire contribution paid into the trust fund for him by his employer or employers would be forfeited. Moreover, Local 705's pension plan required continuous service with covered employers. A violation of this "break in service" rule also resulted in a forfeiture of all pension benefits. 561 F.2d at 1227-28.
11. Id. at 1225.
12. Id. at 1226.
13. Id. at 1226-27.
In the district court, the defendants filed motions seeking dismissal of the action on grounds of lack of subject matter jurisdiction and failure to state a claim. Judge Kirkland denied these motions and held that the anti-fraud provisions of the securities acts were applicable to union members' interests in local pension funds. On appeal, the Seventh Circuit, in a lengthy opinion by Judge Cummings, affirmed Judge Kirkland's denial of the motion to dismiss, and held that the complaint alleged the sale of a security for purposes of application of the anti-fraud provisions of the securities acts.

Providing an overview of his opinion, Judge Cummings stated, in the order of their importance, the relevant factors in determining whether plaintiff's interest in the pension fund constituted the sale of a security:

Analysis begins with the relevant statutes themselves. After a study of their language and any court-added gloss, attention shifts to the statutes' legislative history. Additional considerations weigh in the balance. The history of the SEC's administration of the securities laws often can add a substantive gloss of its own which is entitled to the usual administrative deference. . . . so long as it does not become law-making . . . . And to the extent that these more cogent interpretive tools are not dispositive of the statutes' meaning, additional considerations of policy may tip the scales. . . . We shall use this methodology in our analysis of the case.

In accordance with Judge Cummings' proposed method of analysis, the first important inquiry to be resolved was whether the employee's interest in the pension fund was a security as defined by: (1) relevant statutory language; and (2) the relevant case law interpreting and applying such language. The defendant-employer asserted that a union member's interest in a pension fund was not a "security" as that term is defined in section 2(1) of the Securities Act of 1933, and in section 3(a)(10) of the Securities Exchange Act of 1934. The court of appeals, however, found that such an interest constitutes an "investment contract" as that term is used in both definitions of the word "security."

Referring to the definition of investment contract outlined by the

15. 561 F.2d at 1244.
16. Id. at 1229.
19. The court stressed that in defining the word "security", two principles were important: first, the remedial nature of the securities laws, and the consequent necessity for their broad construction; and second, that in attempting to define the term "security" economic reality should be given preference to the form by which a particular interest is denominated. 561 F.2d at 1230-31.
Supreme Court in SEC v. W.J. Howey Co., the court stated that an investment contract is

a contract, transaction or scheme whereby a person invests his money in a common enterprise and is led to expect profit solely from the efforts of the promoter or a third party, it being immaterial whether the shares in the enterprise are evidenced by formal certificates or by nominal interests in the enterprise.

The court found that all of the elements of the Howey test were satisfied in the case of a union member's interest in a pension trust fund. Judge Cummings stated that a union member was clearly an investor with respect to the fund, noting that employer contributions to a pension fund are simply a part of an employee's total compensation package and that such contributions constitute "putting money into a fund for an employee's future use which he would otherwise be getting in his paycheck." Judge Cummings rejected arguments by certain defendants that the contingent nature of the employee's expectation with respect to pension benefits rendered nugatory any interest such an employee may have in the fund. In the court's opinion, "mere contingent expectancies are the rule rather than the exception in the equity markets" and "a right to receive benefits, received as a form of compensation and not subject to unilateral withdrawal by the pension trustee or the employer, is a sufficient interest to constitute a security, even though it will only mature upon the happening of certain events in the future." The court also had little difficulty finding that the trust fund constituted a "common enterprise" under Howey, ruling that a trust fund (in which union members had an undivided interest), which invests in the capital markets was a common enterprise, despite the fact that a union member could not transfer his interest.

The final requirement of the Howey test is that the common enterprise generate profits. Defendants in Daniel contended that this element had not been satisfied. In the case of United Housing Federation, Inc. v. Forman, the Supreme Court defined profits to mean either "capital appreciation resulting from the development of the initial investment" or "a participation

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21. 561 F.2d at 1231 (quoting SEC v. W.J. Howey Co., 328 U.S. 293 298-99 (1946)). The court of appeals also cited the restatement of the Howey rule contained in United Housing Federation, Inc. v. Forman, 421 U.S. 837, 852 (1975): "The touchstone is the presence of an investment in a common venture premised on a reasonable expectation of profits to be derived from the entrepreneurial or managerial efforts of others."
22. 561 F.2d at 1232.
23. Id. at 1233.
24. Id.
25. Id.
26. See text accompanying note 21 supra.
in earnings resulting from the use of investors' funds." 28 Applying the Forman definition of profit to the facts of Daniel, Judge Cummings noted the obvious fact that "the expected payout to a beneficiary [under a pension plan] will exceed the contributions made by the employer on the employee's behalf (the union member's investment). The resulting gain would commonly be termed a profit." 29 Since a substantial portion of that gain would be attributable to the union member's investment, 30 the Forman definition of profit—and the final element of the Howey test—was met.

After analyzing the union member's interest in his pension plan under a literal application of the Howey test, Judge Cummings stressed that such an interest must also be a security in economic reality. 31 In this regard, Judge Cummings noted that pension funds were remarkably similar to mutual funds. 32 Both funds represented a "pool of money" invested for the benefit of the mutual fund shareholder or union member by the pension fund or mutual fund manager. In addition, in both cases the amount of the payout to the shareholder or union member depends upon the money management skill of the fund managers. Judge Cummings also analogized a union member's interest in his pension fund to a variable annuity contract, which has long been held to be a security under the securities acts. 33 These factors led Judge Cummings to the conclusion that a union member's "interest in the fund embodies many of the significant characteristics typically present in the instruments concededly covered by the securities act." 34

In addition to the language of the statutes and case interpretation, the Seventh Circuit also found support for its holding in the legislative history and SEC interpretations of the securities acts. Judge Cummings noted the rejection of a proposed 1934 Senate amendment to the Securities Act of 1933, 35 which would have exempted from registration an offering made solely to employees of an issuer in connection with a bona fide plan for the payment of extra compensation. 36 The reason why this proposed amendment had been rejected in conference was the need to protect participants in such plans who "may be in as great need of protection afforded by availability of information concerning the issuer for which they work as are most other

28. Id. at 852.
29. 561 F.2d at 1234.
30. The court acknowledged a portion of the gain would also derive from non-investment sources such as the "pooled" contributions of all participating employers and the forfeitures of employees who had failed to satisfy various vesting and other requirements of the plan. Id.
31. Id. at 1236.
32. Id.
33. Id.
34. Id.
35. Hereinafter referred to in the text as the 1933 Act.
36. 561 F.2d at 1237.
members of the public." Judge Cummings also found support in the fact that Congress, by specifically exempting pension funds that are maintained by a bank or by an insurance company in a separate account from the registration requirements of the 1933 Act and the reporting requirements of the Securities Exchange Act of 1934, had evidenced its agreement with the SEC’s position that interests in pension funds are securities. In the Seventh Circuit’s view, the “1970 Amendments show that Congress intended to conform the 1933 Act to the SEC’s administrative view that, although interests in pension funds did not need to be registered in most cases, they are nonetheless securities." 

Finally, Judge Cummings turned to the policies behind the securities acts for further support of the proposition that union members’ interests in pension funds are securities. Perhaps the most crucial factors which influenced the Seventh Circuit to find these interests in pension funds to be securities were the amount of money controlled by such funds, the number of union members with an interest in such funds, and the tremendous role played by pension funds in the capital markets.

The court noted that by 1962, 83% of invested capital was invested indirectly and that pensions constituted 27% of this amount. Moreover, the asset value of pension plans has exceeded the combined total accumulated by mutual funds, life insurance companies, and property and liability insurance companies. Judge Cummings succinctly summarized the relevant policy considerations:

Because employee pension plans are now the major, if not sole, form of investment for most American workers to provide for their old age and because of the now crucial role that such plans play in today’s capital markets, they are just the sort of investment vehicle that the securities acts were passed to regulate. To proclaim that the securities laws encompass securities consisting of interests in pension plans is “quite consistent with the congressional enactment and with the role of the federal judiciary.

37. Id. at 1238 (quoting H.R. REP. No. 1838, 73d Cong., 2d Sess. 41 (1934)).
40. 561 F.2d at 1241.
41. As Judge Cummings stated:
Because of favorable tax provisions and economies of scale, pension funds are the most efficient way for an employee to invest . . . . On a relative scale, his pension plan will probably be a Teamster member’s largest investment. On an aggregate basis private pension funds control a huge amount of the capital markets. At the end of 1972, they held 11% in value of all New York Stock Exchange listed stocks and in the same year they accounted for over 23% of the dollar value of all shares traded there. If the sole investment vehicles for tens of millions of Americans which in the aggregate control a quarter or more of the entire capital market are exempt from the anti-fraud provisions of the securities laws, then policing of the capital markets is significantly neutralized.

Id. at 1237.
42. Id. at 1241.
43. Such plans currently have book value assets of $216.9 billion. Id.
in interpreting it" . . . . The type of fraud allegedly perpetrated on the plaintiff is among those the securities laws were passed to prevent and remedy.\(^4\)

Having determined that plaintiff's interest constituted a security, the Seventh Circuit then held that that interest had been acquired in a "sale." Turning to the definitions of "sale" in the 1933 and 1934 Acts, Judge Cummings stated that:

a "sale" of an interest in a pension fund depends upon whether there has been a disposition of it. Here plaintiff acquired an interest in the Local 705 Pension Fund, and as shown, that interest is a security. Therefore, there necessarily has been a disposition of a security to plaintiff within the scope of the two Acts.\(^4\)

Although Judge Cummings reasoned that the compulsory nature of the employer contributions did not affect this conclusion because the definition of "sale" in the securities acts does not require volition,\(^4\) a volitional element was nonetheless involved in the "sale" of such interests since union members voted whether to ratify collective bargaining contracts containing pension fund provisions.\(^4\) Moreover, the court observed that an employee's decision to remain employed by covered employers "results in his continuing to give value in the future and in the further acquisition of interests in the pension fund."\(^4\)

Once the court had established that the plaintiff's interest in a pension fund constituted a security that had been acquired in a sale, it had no difficulty in finding that section 17(a) of the 1933 Act\(^4\) created a private

44. *Id.* at 1241-42 (citation omitted).
45. *Id.* at 1242. As Judge Cummings noted, the 1933 Act requires that any sale of a security be "for value." However, the court found that an employee's services given in exchange for his employer's contributions to the pension fund constitute value. *Id.*
46. *Id.* at 1243.
47. *Id.*
48. *Id.* The Seventh Circuit agreed with the SEC's rejection of that agency's prior position that no sales were involved in non-contributory plans because the employer's contribution was considered a gift. The court noted that this position was no longer viable even as to the registration provisions because non-contributory pensions are no longer viewed as a mere gift. Even though the Commission had in the past applied a no-sale rule to pension trusts as to the registration requirements of the 1933 Act, that rule was not administratively and should not be judicially applied to the anti-fraud provisions of both Acts.
49. 15 U.S.C. § 77q(a) (1970) provides that:

(a) It shall be unlawful for any person in the offer or sale of any securities by the use of any means or instruments of transportation or communication in interstate commerce or by the use of the mails, directly or indirectly—

(1) to employ any device, scheme, or artifice to defraud, or
(2) to obtain money or property by means of any untrue statement of a material fact or any omission 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
(3) to engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser.
cause of action under the facts of the Daniel case. Although defendants argued that section 17(a) was concerned with the initial issuance of securities and that only the 1934 Act was relevant with respect to the resale market, the court ruled that once a section 10(b) claim had been established, there was little point in denying a cause of action under section 17(a). In a footnote, Judge Cummings conceptualized the securities distribution process involved in a pension fund:

Here the security is plaintiff's interest in the pension plan. These interests generically arose when the pension plan was first formed for the benefit of Local 705 members. This was the primary distribution of the securities. Since Daniel was a member of Local 705 at this time, he has standing to sue for fraud in the primary distribution under Section 17(a) of the 1933 Act. Each year Daniel paid more value into the fund and from time to time plan amendments were effected which Daniel claims contributed to his being defrauded. This is the conceptual predicate for finding a secondary distribution under Section 10(b) of the 1934 Act.

The final issue resolved by the Daniel court was whether the provisions of ERISA preempted the anti-fraud provisions of the federal securities laws with respect to their applicability to pension funds. The court observed that since those anti-fraud provisions were demonstrably applicable to such interests, “preemption may only be declared in the face of an explicit repealer provision or the most cogent repugnancy between the securities and pension regulatory schemes.” Judge Cummings determined that these standards had not been met.

Judge Cummings first observed that ERISA itself contained a general savings clause which provided that nothing in that act was to be construed as a repeal of any federal or state statutes. Any preemption claim, the court ruled, was based on a confusion between the registration requirements of the securities acts and their anti-fraud provisions. With respect to the latter, the court stressed that “the anti-fraud provisions do not establish an affirmative disclosure system requiring the filing of documents. Rather the anti-fraud provisions are essentially a generalized self-executing prohibition against fraudulent activity. There is no invitation ‘to create a federal common law governing the management of pension plans.’” With this understanding,

51. 561 F.2d at 1245.
52. Id. at 1246 n.46.
54. 561 F.2d at 1246.
55. Id.
56. Section 1144(d) provides that “[n]othing in this subchapter shall be construed to alter, amend, modify, invalidate, impair, or supersede any law of the United States . . . or any rule or regulation issued under any such law.” 29 U.S.C. § 1144(d) (Supp. IV 1974).
57. 561 F.2d at 1247.
the provisions of ERISA and the anti-fraud provisions of the securities acts could be read in a complementary manner:

Reading the anti-fraud provisions of the securities laws to be complementary to the requirements of ERISA makes good sense. The requirements of ERISA do not substitute for the protections afforded by the anti-fraud provisions because the securities laws require that all material facts, including, of course, risk of loss, be disclosed prior to the investment decision . . . while ERISA disclosure limits itself to the plan provisions without a particularizing of how or how likely benefits may be lost . . . and may be made 90 days subsequent to the investment commitment.  

Thus, the anti-fraud provisions of the securities acts protect an investor prior to making an investment decision, while ERISA protects "employees who have been employed for a substantial period of time at a job covered by a pension plan, protecting them from losing benefits through ignorance of the plan provisions."  

In conclusion, Judge Cummings carefully circumscribed the scope of the Daniel opinion:

[W]e wish to emphasize that we are not holding the registration requirements of the 1933 Act or the reporting requirements of the 1934 Act to be applicable to these pension funds. We do not require the filing of any document or establish judicial control over pension fund operations. There should be no undue burden caused by the type of disclosure the anti-fraud provisions would encourage because all of the material information will be readily available to the plan trustees since their actuaries needed all the information in order to set up the plan in the first place.

Moreover, plan liability, given the fact that employees' interests in pension funds are covered by the anti-fraud provisions of the securities acts, is still limited by a number of factors. Particular employees must show, in light of all the ambient circumstances, justifiable reliance on a material misrepresentation or omission causing him injury. If all material facts are disclosed in a manner comprehensible to the average worker, as in any other securities fraud case, no damage causation will exist under the securities laws.  

Judge Tone filed a separate concurring opinion in Daniel, stating that "for me, this is a close and difficult case" and that "the series of transactions by which Daniel acquired his interest or expectancy, such as it

58. Id. at 1248.
59. Id. at 1249. The Daniel court also dismissed as specious arguments that affirmance of Judge Kirkland's decision would undermine a union's authority as exclusive bargaining agent for its employees, holding instead that "application of the antifraud provisions of the securities laws should enhance federal labor policy by augmenting the unchallenged statutory right of workers to be fairly represented by their union. . . ." Id. at 1249-50.
60. Id. at 1250-51.
61. Id. at 1251 (Tone, J., concurring).
was, do not fit neatly into the traditional concept of a sale of a security.\textsuperscript{62}

Judge Tone also criticized the SEC for what he considered a recent change in position on the question of whether a union member's acquisition of an interest in a pension fund involved the sale of a security, remarking that:

\textit{\[a\]s late as 1971 in its Institutional Investors Study submitted to Congress in connection with the consideration of the ERISA legislation, the Commission's view was that although a noncontributory pension plan might well be an investment contract, the element of sale was lacking. Before that not even the existence of a security was acknowledged.\textsuperscript{63}}

Judge Tone concluded, however, that while Congress could be considered as having acquiesced in the SEC's prior view as to the status of interests in pension funds as securities, that fact alone did not preclude a judicial finding that such interests were securities and thus subject to the anti-fraud provisions of the securities acts.\textsuperscript{64}

The Daniel decision does resolve one difficult question left open by Judge Kirkland's decision in the district court, \textit{i.e.}, whether pension plans such as that involved in Daniel are subject to the registration requirements of the 1933 Act. The Seventh Circuit emphatically held that they are not. Nonetheless, the Daniel opinion raises other problems.

One is precisely what items are material and therefore need to be disclosed to union members in connection with pension plans. Clearly, the Seventh Circuit attached great importance to the actuarial possibility of a member's eventually receiving any pension benefits; Judge Cummings mentions that factor several times in his opinion. More particularly, such matters as the vesting period and any rules comparable to the "break in service" rule involved in Daniel clearly require disclosure, as would any forfeiture provisions in connection with those rules. However, the Seventh Circuit was clearly not creating an exclusive list of disclosure items which would satisfy in all cases all the requirements of the anti-fraud provisions.

Another issue left open by the Daniel court is the mechanism by which the required disclosure is to be made. Although the registration requirements of the 1933 Act\textsuperscript{65} are not applicable in such cases, some type of disclosure document must be distributed to union members explaining in readily comprehensible form detailed and intricate information as to the plan provisions.

\textsuperscript{62} Id.
\textsuperscript{63} Id.
\textsuperscript{64} Id. at 1252.
One of several questions left open by the Supreme Court’s decision in *Ernst & Ernst v. Hochfelder* was whether reckless conduct amounting to a willful disregard for the truth satisfies the requirement of scienter necessary to establish a violation of section 10(b) of the 1934 Act and rule 10b-5 thereunder, thus giving rise to a private cause of action for damages. The Seventh Circuit has clearly answered this question in the affirmative and has attempted to fashion a standard of “recklessness” which is the equivalent of scienter.

*Bailey v. Meister Brau, Inc.*, decided during the Seventh Circuit’s 1975-76 term and shortly after the Supreme Court’s decision in *Hochfelder*, indicated that the Seventh Circuit would consider recklessness to be sufficient to satisfy the scienter requirement in certain cases. In *Bailey*, the Seventh Circuit upheld the district court’s finding that defendant, Continental Illinois National Bank and Trust Company of Chicago, was guilty of violating rule 10b-5 on the grounds that it was “grossly negligent” in failing to recognize the unfairness of an asset transfer by a corporation it controlled as executor of an estate and was “blinded by a conflict of interest” causing it to “wantonly ignore evidence of the unfairness of [the] securities transaction to the corporation.” While Judge Bryan stated that this decision was consistent with *Hochfelder*, the *Bailey* court did not articulate a standard of recklessness sufficient to meet the scienter requirement. Moreover, the decision to impose rule 10b-5 liability was heavily influenced by the fact that, as a controlling stockholder, Continental stood in a fiduciary relationship to plaintiff and, thus, had “the obligation to disclose to the other stockholders information in its possession which reflects on the fairness of the transaction.”

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66. 425 U.S. 185 (1976). In *Hochfelder*, the Court held that a private cause of action for damages under section 10(b) of the Securities Exchange Act of 1934 and rule 10b-5 thereunder requires an allegation of scienter on the part of the defendant.
69. In *Hochfelder*, the Supreme Court mentioned the possibility that recklessness might, in certain cases, in and of itself, amount to scienter:

In this opinion the term “scienter” refers to a mental state embracing intent to deceive, manipulate, or defraud. In certain areas of the law recklessness is considered to be a form of intentional conduct for purposes of imposing liability for some act. We need not address here the question whether, in some circumstances, reckless behavior is sufficient for civil liability under § 10(b) and Rule 10b-5.

70. 535 F.2d 982 (7th Cir. 1976).
71. *Id.* at 993.
72. Judge Bryan simply stated *Hochfelder* contained “nothing to the contrary,” referring to footnote 12 of the Supreme Court’s opinion. *Id.* at 994 n.14.
73. *Id.* at 993.
During the past term, *Sundstrand Corp. v. Sun Chemical Corp.*\(^4\) further refined the recklessness standard intimated in *Bailey*. In *Sundstrand*, the plaintiff was engaged in merger negotiations with Standard Kollsman Industries, Inc.\(^7\) As a part of those negotiations, and in an effort to prevent Sun Chemical from acquiring a block of SKI stock large enough to thwart a Sundstrand/SKI merger before Sundstrand could complete its study of SKI, Sundstrand agreed to purchase a stock option for approximately 200,000 shares of SKI held by Huarisa, the chairman of SKI. Under the terms of the stock option and the agreement between Sundstrand and Huarisa with respect to its purchase, Sundstrand was to reimburse Huarisa for his payment of 5\% of the purchase price of the 200,000 shares\(^6\) and to pay the $6,000,000 balance of the purchase price to the family of the founder of SKI, which owned the shares subject to the option.\(^7\)

After Sundstrand had an opportunity to review the operations of SKI, it broke off merger discussions, but announced that it would honor its "commitment" to purchase the remaining shares of stock covered by the agreement with Huarisa. After making this $6,000,000 payment, Sundstrand sued Sun Chemical (which had in the meantime acquired SKI) and Meers, a managing partner of White, Weld & Co., which had acted as merger broker in connection with the Sundstrand/SKI negotiations, alleging violations of section 10(b) and rule 10b-5 entitling it to recover payments made pursuant to the agreement with Huarisa.

Judge Cummings, who was joined by Judges Swygert and Fairchild in a unanimous decision, had little difficulty in holding that the material misstatements of Huarisa and other SKI personnel in connection with the merger negotiations violated rule 10b-5 and satisfied the scienter requirement set forth in *Hochfelder*. The court found that Huarisa and other SKI personnel had not only misstated the earnings of SKI, and had given misleading per share earnings projections, but had also failed to disclose a dissident director's report that questioned certain accounting practices of SKI with respect to deferral of preproduction costs and nonrecognition of certain losses. The court also found that Huarisa and other SKI personnel had not disclosed an independent report of the accounting firm of Ernst & Ernst prepared at the request of the dissident SKI director that also criticized SKI's accounting practices.\(^8\)

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\(5\) Hereinafter referred to in the text and footnotes as SKI.

\(6\) This was accomplished by Sundstrand's transfer to Huarisa of 5,686 shares of its common stock.

\(7\) 553 F.2d at 1037.

\(8\) The opinion is not particularly clear as to the standard used in finding scienter in the case of Huarisa and SKI. Judge Cummings states that the misrepresentations were made...
The more interesting holding in *Sundstrand*, however, is that Meers, as merger broker, was also liable under rule 10b-5 for the injury suffered by Sundstrand in view of his failure to disclose reports by the dissident director and Ernst & Ernst. Judge Cummings stressed that, although he was an SKI director, Meers occupied a quasi-fiduciary relationship to Sundstrand because he was also a member of an investment banking firm which had performed services for that corporation. Therefore, "Meers had an affirmative common law duty to disclose material facts relating to the proposed merger," in express contrast to the lack of any such duty owed by Ernst & Ernst to the plaintiffs in *Hochfelder*.

Since the district court had decided Meers’ culpability without reference to *Hochfelder*, the Seventh Circuit felt obliged to make an independent finding as to whether his conduct was sufficiently reckless to satisfy the scienter requirement. In an effort to ascertain the point at which reckless conduct amounts to scienter, Judge Cummings first interpreted the *Bailey* decision to mean that "a reckless omission of material facts upon which the plaintiff put justifiable reliance in connection with a sale or purchase of securities is actionable under section 10(b) as fleshed out by rule 10b-5." He then adopted the definition of recklessness formulated in *Franke v. Midwestern Oklahoma Development Authority*:

[R]eckless conduct may be defined as a highly unreasonable omission, involving not merely simple, or even inexcusable negligence, but an extreme departure from the standards of ordinary care, and which presents a danger of misleading buyers or sellers that is either known to the defendant or is so obvious that the actor must have been aware of it.

Judge Cummings interpreted this definition of recklessness to create a two-pronged test consisting of an "objective" element, *i.e.*, the danger of misleading buyers must be actually known or so obvious that any reasonable man would be legally bound as knowing, and a "subjective" element, *i.e.*, the failure to disclose must be due to something more than even "white heart/empty head" good faith or inexcusable negligence. Under this test, recklessness could be considered "the functional equivalent of intent."

intentionally or recklessly and that the district court had not erred "in using the 'reckless' alternative in assessing Huarisa's liability. . . ." *Id.* at 1040.

79. *Id.* at 1043.

80. The need to make such a finding was even greater because Meers' conduct consisted of reckless nondisclosure, rather than disclosure with a reckless disregard for the truth of the matter disclosed.

81. 553 F.2d at 1044.


83. *Id.* at 725 (cited in 553 F.2d at 1045).

84. 553 F.2d at 1045.
Applying this two-pronged test to Meers' conduct, the Seventh Circuit first held that the objective element of the *Franke* test had been satisfied. Meers had not only participated in merger negotiations in which the earnings figures had been discussed, but also had been familiar with the reports of both the dissident director and Ernst & Ernst. Under these circumstances, the court concluded, any reasonable man would realize the danger of misleading Sundstrand through the failure to disclose the information known to Meers. The court then held that the subjective element of the *Franke* recklessness test was also satisfied. Meers was present at a board meeting of SKI when the dissident director asked if Sundstrand had been informed of his report and the Ernst & Ernst criticisms of SKI's accounting practices at any time during the merger negotiations. In response to this inquiry, Huarisa stated that Sundstrand had not been so informed. Under these circumstances, Judge Cummings stated, "Meers must have consciously decided not to disclose (and did not disclose) the substance of the reports to Sundstrand." Since Meers was thus chargeable with knowledge that the nondisclosure would pose a material danger to plaintiff and made a conscious decision not to disclose such information, his conduct amounted to reckless nondisclosure satisfying the scienter requirement of rule 10b-5.

The next decision discussing the recklessness standard was *Sanders v. John Nuveen & Co.* *Sanders* involved a class action on behalf of purchasers of short-term notes underwritten by defendant John Nuveen & Co. When the case was last before the Seventh Circuit in 1975, the court affirmed the judgment of the district court and held that "an underwriter of short-term commercial paper who acted in the mistaken but honest belief that financial statements prepared by certified public accountants correctly

85. Id. at 1047.
86. Id. at 1047-48.
87. Id. at 1048-49. Although Sundstrand was thus victorious on its 10b-5 claim, the decision of the Seventh Circuit effectively negated the district court's award of damages to Sundstrand. The Seventh Circuit held that Sundstrand's payment of the remaining 95% of the purchase price of the 200,000 shares subject to its stock option transfer agreement with Huarisa was made upon erroneous legal advice as to the necessity for such payment, and at a time when it already had knowledge of most, if not all, of the material misrepresentations and omissions of the defendants in the course of the merger negotiations. As a result, the court held that defendants were not liable for the $6,000,000 balance of the purchase price of the shares, since the chain of causation had been broken by both Sundstrand's knowledge and the erroneous legal advice it received. Id. at 1051.
88. 554 F.2d 790 (7th Cir. 1977).
89. Plaintiffs asserted claims under, *inter alia*, section 10(b) of the 1934 Act and rule 10b-5 thereunder, sections 12(2) and 17 of the 1933 Act, and Rule 27 of the National Association of Securities Dealers, Inc. See text accompanying notes 89-106 infra.
90. 524 F.2d 1064 (7th Cir. 1975), vacated, 425 U.S. 929 (1976). The *Sanders* case had been before the Seventh Circuit on an earlier occasion. In its first *Sanders* decision, Sanders v. John Nuveen & Co., Inc., 463 F.2d 1075 (7th Cir.), *cert. denied*, 409 U.S. 1009 (1972), the Seventh Circuit held that such short-term notes were "securities" within the definition of the 1934 Act.
represented the condition of the issuer" was liable under rule 10b-5 to its customers for losses sustained as a result of the issuer’s default. In short, the decision held that the underwriter’s negligence was actionable under rule 10b-5.

The Supreme Court vacated the decision of the Seventh Circuit in Sanders and remanded the case for consideration in the light of Hochfelder. In its decision on remand, the Seventh Circuit noted that although Hochfelder, in determining that rule 10b-5 required a finding of scienter, had left open the question of whether reckless conduct was sufficient to constitute scienter, the opinions in Bailey and Sundstrand had settled the question in the affirmative. Judge Wood, however, drew more careful restrictions around the recklessness test than had Judge Cummings in Sundstrand:

In view of the Supreme Court’s analysis in Hochfelder of the statutory scheme of implied private remedies and express remedies, the definition of "reckless behavior" should not be a liberal one lest any discernible distinction between "scienter" and "negligence" be obliterated for these purposes. We believe "reckless" in these circumstances comes closer to being a lesser form of intent than merely a greater degree of ordinary negligence. We perceive it to be not just a difference in degree, but also in kind.

The court then held that there was no evidence at trial that "[Nuveen's] acts of commission or omission were reckless, that is, that they were so highly unreasonable and such an extreme departure from the standards of ordinary care as to present a danger of misleading the plaintiff to the extent that the danger was either known to the defendant or so obvious that the defendant must have been aware of it." "

In addition to the issue involving the degree of recklessness necessary to constitute scienter for rule 10b-5 purposes, the Seventh Circuit also considered other issues presented by the case but not specifically mentioned in the Supreme Court’s mandate on vacation of its initial decision. The first issue was whether the judgment of the district court could be sustained under section 17(a) of the 1933 Act. Although the language of section 17(a) parallels that of rule 10b-5, it has been argued that the Hochfelder decision would not necessarily dictate a scienter requirement in a section 17(a) action because the "misstatements and omissions" language of section 17(a)(2) is not qualified by any traditional fraud language, while the Supreme Court in

91. 524 F.2d at 1066.
93. 554 F.2d at 793.
94. Id.
Hochfelder had emphasized the presence of fraud concepts in section 10(b) and had stressed that since rule 10b-5 had been adopted pursuant to that section it was qualified by those underlying concepts.  

Although Judge Wood discussed the disputed question of whether a private right of action may be maintained under section 17(a), he found no need to resolve this issue because "even if such a private cause of action does exist under section 17(a), it would require proof of scienter." In so holding, the Sanders opinion relied upon the Supreme Court's discussion in Hochfelder of the express provisions for civil liability premised upon negligent wrongdoing contained in sections 11 and 12(2) of the 1933 Act and the consequent implication that section 10(b) of the 1934 Act required more than negligent misrepresentation or nondisclosure. The Seventh Circuit found this analysis equally applicable to the anti-fraud provisions of section 17 of the 1933 Act.

Plaintiffs in Sanders also argued that the judgment of the district court could be sustained on grounds of a violation by Nuveen of Rule 27 of the National Association of Securities Dealers. That rule requires members of the association to establish, maintain, and enforce written procedures for the purchase and sale of securities. The Sanders court cited several cases

97. 554 F.2d at 795.
99. 554 F.2d at 796.
100. Id.
101. Rule 27 of the National Association of Securities Dealers, Inc., provides in pertinent part:

Written procedures
(a) Each member shall establish, maintain and enforce written procedures which will enable it to supervise properly the activities of each registered representative and associated person to assure compliance with applicable securities laws, rules, regulations and statements of policy promulgated thereunder and with the rules of this Association.

Responsibility of member
(b) Final responsibility for proper supervision shall rest with the members. The member shall designate a partner, officer or manager in each office of supervisory jurisdiction, including the main office, to carry out the written supervisory procedures. A copy of each such procedures shall be kept in each such office.

Written approval
(c) Each member shall be responsible for keeping and preserving appropriate records for carrying out the member's supervisory procedures. Each member shall review and endorse in writing, on an internal record, all transactions and all correspondence of its registered representatives pertaining to the solicitation or execution of any securities transaction.

Review of activities and annual inspection
(d) Each member shall review the activities of each office, which shall include the periodic examination of customer accounts to detect and prevent irregularities or
finding an implied civil private damage action for violations of the rules of securities exchanges and associations, but stressed that in each such case there had been a finding that the violation of the rule involved amounted to fraudulent conduct. The Sanders court noted that the district court had not made any finding of fraud and that as a consequence no implied cause of action under rule 27 was available. The Seventh Circuit's holding with respect to rule 27 suggests that violations of a dealer association's rules, just as violations of the anti-fraud provisions of the securities acts, require a finding of scienter to give rise to implied civil liabilities. Indeed, the requirement may be even more stringent with respect to the former since the Seventh Circuit did not discuss, nor even suggest, the possibility that reckless conduct would be sufficient to support a civil action for damages based on a violation of such rules.

Finally, the Sanders court considered the final possible basis on which the judgment of the district court could be upheld—section 12(2) of the 1933 Act. After reviewing the decision of the district court, the Seventh Circuit concluded that the issue of section 12(2) liability had not been passed upon by that court. The court therefore reversed and remanded the decision for further findings of fact as to liability under section 12(2), denying defendants' motion for summary reversal.

A final decision discussing the recklessness standard under the anti-fraud provisions of the securities acts is Wright v. Heizer Corp. In Wright, the plaintiff was a minority shareholder in International Digisonics Corporation. Defendant Heizer Corporation had acquired, through a series of three financings with IDC involving the purchase by Heizer of IDC preferred stock and warrants to purchase IDC common stock, a 61% ownership interest in IDC's equity. Two Heizer officers also became members of IDC's Board of Directors. In a fourth transaction, Heizer agreed to loan $600,000 to IDC which, if not paid at maturity, would become convertible into common stock of IDC. At that point, antidilution clauses contained in the warrants obtained by Heizer in previous financings would be triggered
and Heizer would become entitled to shares of IDC common stock, giving it approximately 85% of IDC’s equity. Because the shares required to be issued to Heizer in such event were more than the authorized shares of common stock of IDC, it was necessary to obtain approval from the common shareholders for a charter amendment increasing the authorized shares of IDC.110 This was secured by written consents prepared and circulated by Heizer and executed by the common shareholders. After the lawsuit was instituted, in a fifth transaction Heizer made further loans to IDC, taking as security a pledge of all of the stock of IDC’s only valuable subsidiary.111 At the time of the pledge, Heizer controlled three of the four IDC directors.112

The Seventh Circuit held that full disclosure had not been made with respect to the solicitation of consents from the shareholders in connection with the fourth financing.113 The court further held that because Heizer controlled the board of directors of IDC at the time of the pledge transaction, only the independent shareholders were able to safeguard IDC’s interests, and consequently disclosure of the pledge to the board of directors was insufficient under rule 10b-5. The court reached this holding despite the fact that at the time of the pledge transaction Heizer did not control the entire board of directors but only a majority of such directors. The court held that:

Under these circumstances, Heizer was obliged to disclose the material facts concerning the [pledge] transaction to the independent shareholders prior to its consummation. This obligation was not fulfilled: the shareholders were first informed of the general terms of the pledge and the reasons therefor two months after the transaction. Thus, we hold that Rule 10b-5 was also violated by Heizer’s failure to disclose material facts to the corporation in the fifth transaction.114

The Seventh Circuit then stressed that in addition to proving this violation of the disclosure requirements of rule 10b-5, plaintiffs were also required under Hochfelder to show reliance on material misrepresentations and scienter.115 With respect to reliance, the Seventh Circuit first cited the

110. Heizer Corporation, although it held preferred stock and warrants to purchase shares of common stock, did not actually own any common stock of IDC. Id.
111. Id. at 245.
112. Id. at 248.
113. Heizer, although it did not control a majority of IDC’s Board at the time of the fourth transaction, “assumed responsibility for the inadequacy of the disclosure when it undertook to control and supervise IDC’s communications to its shareholders.” Id.
114. Id. at 249. The Seventh Circuit thus found rule 10b-5 liability in connection with the pledge transaction even though stockholder approval of the transaction was neither required nor sought and no statements had been made to any stockholders in connection therewith. The decision thus appears to parlay a state law requirement for securing stockholder approval to defend against a charge of self-dealing into an affirmative rule 10b-5 duty to disclose.
115. Id.
rule pronounced in *Affiliated Ute Citizens v. United States*\(^{116}\) that in a rule 10b-5 case, proof of materiality is sufficient to establish reliance. Because the common shareholders had the power under state law to veto the fourth transaction entirely by disapproving the required increase in authorized shares, failure to disclose the terms of the transaction was clearly material, and consequently reliance was established.\(^{117}\) With respect to the fifth transaction, since the minority shareholders could have brought a derivative action in state court to enjoin any breach of Heizer’s fiduciary duty to deal fairly with the corporation with respect to the pledge, the existence of reliance hinged upon the fairness of the pledge itself. In making such a determination, the Seventh Circuit ruled that there was a heavy presumption of unfairness:

> Given the obvious risks of unfairness created by the Heizer Corporation’s limited view of its fiduciary responsibility, the presumption of unfairness [with respect to the pledge transaction] applied by the District Court was particularly appropriate. As the Court noted, Heizer’s explanations for the pledge did not overcome that presumption.\(^{118}\)

The Seventh Circuit ruled that the pledge was unfair and simply a device to discourage the pending lawsuit. Consequently, reliance had been established.\(^{119}\)

**Scienter**, the second element necessary to find a violation of rule 10b-5 under *Hochfelder*, was also satisfied in the court’s opinion, again using the recklessness standard developed in *Bailey, Sundstrand* and *Sanders*. In *Wright*, the court focused on the “objective” element of the two-pronged test\(^{120}\) developed in *Sundstrand* and *Sanders*, noting that Heizer “must have been aware” that both the fourth transaction and the pledge were highly controversial and would arouse opposition on the part of the common shareholders.\(^{121}\) Nonetheless, Heizer used consent forms which did not disclose the controversial aspects of the fourth transaction, and solicited the consents by having the founder of IDC’s business circulate the consents among his friends who were common shareholders. Since these nondisclosures, as well as the decision by Heizer not to seek shareholder approval of the pledge, were clearly by conscious choice of Heizer and its counsel, the court had little difficulty with the second, “subjective” element of the recklessness test; indeed, that element of the two-pronged test was not even mentioned in the *Wright* opinion.

\(^{117}\) 560 F.2d at 250.
\(^{118}\) *Id.* at 251.
\(^{119}\) *Id.*
\(^{120}\) See text accompanying notes 83-85 *supra*.
\(^{121}\) 560 F.2d at 252.
A final interesting development posed by the *Wright* case was the relief afforded to the plaintiff. The court stated the general rule that in granting relief "a court of equity should attempt to return the parties to the *status quo ante*, unraveling transactions effected through violations of rule 10b-5 to the extent that it may do so fairly and without injuring the rights of innocent parties." 122 The court of appeals then approved the district court's cancellation of the conversion feature of the loans made pursuant to the fourth transaction, as well as cancellation of the IDC charter amendment permitting an increase in the number of authorized common shares. 123 The Seventh Circuit also approved the district court's decision voiding the pledge, holding that the maturities of the loans extended pursuant to the fourth transaction should be extended commensurate with IDC's ability to pay. 124 The court decreed that Heizer should be enjoined from seeking to collect its loans and from threatening (as Heizer had done in a proxy solicitation) to put IDC into bankruptcy unless minority shareholders agreed to a plan of recapitalization favorable to Heizer. 125 Finally, the Seventh Circuit approved an injunction against Heizer to prevent the use of its voting power or its control of IDC's board to compel any securities transactions not approved by a majority of the shareholders other than Heizer (unless it could demonstrate the fairness of the transactions), and also required disclosure by Heizer to the common shareholders of any material facts concerning future transactions in securities of or held by IDC. 126

The Seventh Circuit's development of a recklessness standard for liability under rule 10b-5 appears to be entirely consistent with the Supreme Court's recent admonitions against undue expansion of liability under the securities laws. As indicated by the *Sundstrand* and *Sanders* cases, for conduct to be classified as "reckless" it must bear a closer similarity to an intentional act than to an act that is merely "grossly negligent." These strictures make it highly unlikely that plaintiffs will prevail on rule 10b-5 claims in cases other than those involving conduct by a defendant tantamount to actual fraud. Moreover, the finding of recklessness in *Sundstrand* and *Wright* was heavily colored by the fact that the defendants in those cases occupied a fiduciary or quasi-fiduciary relationship to the plaintiffs, imposing upon them a greater duty of disclosure than might otherwise be the case. Indeed, in *Sanders*, the only case discussing the recklessness standard that did not involve a defendant acting in a fiduciary capacity, the

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122. *Id.*  
123. *Id.* at 253.  
124. *Id.*  
125. *Id.* at 254-55.  
126. *Id.* at 256.
court found that the requirements of the recklessness test had not been satisfied.

DAMAGES IN MERGER SITUATIONS

MILLS V. ELECTRIC AUTO-LITE CO.

The merger case of Mills v. Electric Auto-Lite Co. involved violations of section 14(a) of the 1934 Act and the related proxy solicitation anti-fraud rule. In a lengthy opinion, Judge Swygert developed tests for determining the existence and extent of damages in merger cases involving violation of this type, and held that under these tests, the merger at issue in Mills was a fair one.

Between 1957 and 1962, Mergenthaler Linotype had acquired a 54.2% interest in the stock of Electric Auto-Lite Company. In 1963, Mergenthaler attempted to merge itself and Auto-Lite into a new corporation to be called Eltra Corporation. After a proxy solicitation had secured the necessary two-thirds vote required for ratification of the merger, the merger became effective on June 28, 1963.

Plaintiffs, minority stockholders in Auto-Lite, filed suit seeking to set aside the merger on the grounds that the proxy solicitation materials did not adequately disclose the fact that the Auto-Lite board of directors was controlled by Mergenthaler. When the case was first before the Seventh Circuit, the court of appeals held that the proxy statement was "illegally deceptive," but held that no showing of causality had been made between the proxy statement and the consummation of the merger. On appeal, the Supreme Court reversed the Seventh Circuit, reinstated the judgment of the district court and held that:

Where there has been a finding of materiality, a shareholder has made a sufficient showing of causal relationship between the violation and the injury for which he seeks redress if, as here, he proves that the proxy solicitation itself, rather than the particular defect in the solicitation materials, was an essential link in the accomplishment of the transaction. The Supreme Court also held that since the misrepresentations in the proxy solicitation materials did not relate to the terms of the merger itself, the merger did not need to be set aside. Plaintiffs were entitled to damages only if they could show either: (1) a reduction in the earnings or earnings

132. Id. at 387-88.
potential of their holdings; or (2) if such an earnings reduction could not be determined, unfairness of the merger at the time it was consummated. On remand, the district court held that although the merger should not be rescinded, the basic terms of the merger were unfair. The court awarded damages to plaintiffs in the amount of approximately $1,250,000.

Judge Swygert agreed with the district court’s rejection of the reduction in earnings or earnings potential test as an appropriate measure of damages under the facts of the *Mills* case. Turning to plaintiffs’ assertion that the post-merger record of Eltra showed that it had appropriated assets held by Auto-Lite for its use in other divisions and had siphoned off Auto-Lite’s post-merger earnings, Judge Swygert reasoned that “even if plaintiffs’ assertions are true, they cannot form the basis for an award of damages.” Judge Swygert stressed that after the merger, former shareholders of Auto-Lite were shareholders of Eltra and consequently could not be harmed by transfers of assets between the various subsidiaries and divisions of Eltra. Indeed, Judge Swygert noted, the only possible way in which post-merger earnings would be relevant to a demonstration of unfairness of the merger would be if the ratio of the post-merger earnings of the Auto-Lite division of Eltra to those of the Mergenthaler division was excessively high in comparison to the exchange ratio, since this would indicate that the value of the Auto-Lite shares had been substantially underestimated at the time of the merger.

Judge Swygert added, however, that a comparison of post-merger earnings is only relevant if commingling of the assets of the merged companies has not occurred. In this case, the Seventh Circuit was in accord

133. *Id.* at 388-89.
135. Judge Swygert noted that the merger terms called for the minority Auto-Lite shareholders to receive 1.88 preferred shares of Eltra for each share of Auto-Lite common. A shareholder of Mergenthaler, on the other hand, received one common share of Eltra for each common share of Mergenthaler held by him. At the time of the merger, Auto-Lite shareholders also received a dividend of $2.63 per share, which was 23 cents more than the $2.40 dividend Auto-Lite common had been paying prior to the merger.

Judge Swygert then observed that the average market value of Eltra preferred was $31.06 per share during the month following the merger, and that as a consequence each minority shareholder of Auto-Lite had received stock worth $58.39 on the market for each share of Auto-Lite previously held (1.88 x $31.06 = $58.39). On the other hand, the average market value of Eltra common stock during the same month was $25.25 per share. Thus, each Auto-Lite minority shareholder received stock worth 2.3 times as much on the market per share as each stockholder of Mergenthaler received for each share of Mergenthaler previously held ($58.39/$25.25 = 2.31). The effective exchange ratio, in the court’s opinion, was thus 2.3 to 1.

136. *Id.* at 1242.
137. *Id.*

138. In comparing the ten year post-merger earnings of the Auto-Lite and Mergenthaler divisions of Eltra, Judge Swygert found the ratio to be 4.85, which was considerably higher than the exchange ratio of 2.31. *Id.* at 1243.
with the finding of the district court that "substantial commingling of the assets and operations of Auto-Lite and Mergenthaler during the period following the merger" had occurred.\textsuperscript{139} Moreover, since there had been a substantial improvement in the quality of management obtained by Auto-Lite following the merger, and Eltra had continually underestimated the expenses of its Auto-Lite divisions during the post-merger period, Auto-Lite's earnings in fact had been inflated.\textsuperscript{140} However, even in the absence of these factors, the Seventh Circuit indicated that post-merger earnings are never a totally reliable indicator of the fairness or unfairness of a merger:

Even in the absence of commingling, postmerger evidence can only create a rebuttable inference of unfairness because it is impossible to know with certainty whether the increase in earnings of one partner to a merger should have been predictable at the time the merger took place. In this case the ratio of the earnings per share of the two companies for the four years prior to and including 1963 were all at or below the effective exchange ratio of 2.31:1.\textsuperscript{141}

Judge Swygert then turned to the second criterion for determining whether damages were recoverable by plaintiffs: the basic fairness or unfairness of the merger itself. The district court, relying on the comparative earnings and book values of the two corporations, had found that the merger terms were unfair and that an appropriate exchange ratio would have been 2.35:1.\textsuperscript{142}

The district court had held that an examination of the market value of Auto-Lite and Mergenthaler shares prior to the merger was an inappropriate test of the fairness of the merger because of purchases of Auto-Lite stock by both Mergenthaler and by Auto-Lite itself, and because of purchases of Mergenthaler stock by American Manufacturing Company.\textsuperscript{143} The Seventh Circuit disagreed. First, the court of appeals noted that most of these stock purchases had occurred prior to a six-month period before the merger, and that there was no showing of manipulation of stock prices during the period

\begin{itemize}
  \item \textsuperscript{139} Id.
  \item \textsuperscript{140} Id.
  \item \textsuperscript{141} Id. at 1244.
  \item \textsuperscript{142} Based on this differential of .10 (i.e., the difference between 2.35 and 2.25, which the district court had found to be the actual exchange ratio), the district court calculated damages under a complicated formula based upon the market value of Eltra stock following the merger. As the Seventh Circuit noted, this calculation involved a certain amount of circular reasoning, since the market value of Eltra stock was directly related to the actual exchange ratio. Rejecting this calculation, the Seventh Circuit found that if the differential of .10 was correct, the appropriate measure of damages was simply a multiplication of that differential by the number of minority Auto-Lite shares. The result would be the additional number of Eltra shares required to be issued to the Auto-Lite minority shareholders to make the merger fair. \textit{Id.} at 1244-45. However, as will be discussed, the Seventh Circuit found that the merger terms were fair for other reasons. \textit{See} text accompanying notes 143-152 \textit{infra}.
  \item \textsuperscript{143} Id. at 1244.
\end{itemize}
immediately before the merger in an effort to secure more favorable merger terms. More importantly, the price ratio of Auto-Lite to Mergenthaler stock had remained the same during the time in which such purchases occurred (1961 and 1962), and during the time when few, if any, of such purchases took place (1963). Moreover, even if the purchases had an effect, that effect would be to raise rather than lower the price of Auto-Lite stock.

The Seventh Circuit further noted that during the period immediately prior to the merger, the ratio of purchases of Auto-Lite stock to the total amount of Auto-Lite stock traded was greater than the ratio of the purchases of Mergenthaler by American Manufacturing Company to the total amount of Mergenthaler stock traded. Finally, most of the Mergenthaler purchases of Auto-Lite stock occurred between 1961 and 1963, while the purchases of Mergenthaler stock by American occurred prior to 1961.

Since the usefulness of market value as a test of the fairness of the merger was not reduced by these purchases, the Seventh Circuit next decided that the appropriate period for calculating the price ratio between the two corporations' stock was the six months immediately prior to the merger. The ratio for this six month period was 2:1. Judge Swygert noted that the reliability of this ratio was not weakened because of Auto-Lite's high dividends from 1961-1963, since the payment of dividends would tend to raise rather than lower the value of a corporation's stock. Moreover, by 1961 Auto-Lite's traditional business was eroding and a great deal of market uncertainty had arisen as to the future of the company. In these circumstances, Judge Swygert reasoned that post-1961 market values were a more reliable indication of market value at the time of the merger than were earlier figures based upon a different market view of Auto-Lite's future. Having found market value to be an appropriate measure of the fairness of the merger, the Seventh Circuit rejected the other factors on which the district court relied:

We hold that when market value is available and reliable, other factors should not be utilized in determining whether the terms of a merger were fair. Although criteria such as earnings and book value are an indication of actual worth, they are only secondary indicia. In a market economy, market value will always be the primary gauge of an enterprise's worth . . . . If we were to independently assess criteria other than market value in our effort to determine whether the merger terms were fair, we would be substituting our abstract judgment for that of the market. Aside from the problems that would arise in deciding how much weight

144. Id. at 1245.
145. Id. at 1245-46.
146. Id. at 1246.
147. Id. at 1247.
148. Id.
to give each criterion, such a method would be economically unsound.\textsuperscript{149}

Applying this market value criterion to the merger before it, the court found that the price ratio of 2:1 was well below the effective exchange ratio of 2.31:1 and that on this basis the merger terms were fair. However, Judge Swygert pointed out that the minority Auto-Lite shareholders were entitled to compensation for the synergistic effect of the merger, since the synergism generated by the merger made the new corporation worth more than simply the sum of its two constituent parts.\textsuperscript{150}

To determine whether adequate compensation had been given for this synergistic effect, Judge Swygert first looked to the pre-merger value of the two corporations, based upon average market prices during the first half of 1963. Using the average market value of Eltra shares (both common and preferred) during the month following the merger, Judge Swygert then determined the difference between the combined pre-merger value of Auto-Lite and Mergenthaler and the post-merger value of Eltra, the difference being some $4,200,000. This increase was attributable, in the court's opinion, to the synergism generated by the merger.

According to Judge Swygert, fairness required that:

the minority shareholders of Auto-Lite should have received Eltra stock worth at least as much as the pre-merger market value of their holdings in Auto-Lite and a share of the synergism produced by the merger proportionate to the percentage of the combined pre-merger value of Auto-Lite and Mergenthaler which their holdings represented.\textsuperscript{151}

Thus, the minority shareholders of Auto-Lite were entitled to approximately 29.3\textsuperscript{152} of the $4,200,000 attributable to the synergistic effect of the merger. Had an appropriate number of shares of Eltra stock been distributed to reflect this 29.3\% factor, the exchange ratio would have been 2.16:1, still below the actual exchange ratio of 2.31:1.

Finally, the Seventh Circuit determined that while plaintiffs were entitled to attorneys' fees for that portion of the litigation involving the establishment of a violation of section 14(a) of the 1934 Act, they were not entitled to such fees in connection with their attempt to prove damages. The court held that:

\textsuperscript{149} Id. at 1247-48.
\textsuperscript{150} In formulating this test for determining the synergistic effect of a merger, Judge Swygert followed the analysis outlined in Brudney & Chirelstein, \textit{Fair Shares in Corporate Mergers and Takeovers}, 88 Harv. L. Rev. 297 (1974).
\textsuperscript{151} 552 F.2d at 1248.
\textsuperscript{152} The percentage of the combined pre-merger value of Auto-Lite and Mergenthaler held by the Auto-Lite minority shareholders.
plaintiffs cannot recover fees and expenses unless they demonstrate that their work on the issue of damages produced a common benefit for the former Auto-Lite minority shareholders. Plaintiffs cannot meet this burden. They have conferred no benefit upon the class they represent beyond the 'corporate therapeutics' produced by their showing that the proxy statute was violated, and they must pay their own fees and expenses for their unsuccessful attempt to obtain damages for that violation.153

MISCELLANEOUS DECISIONS

A number of other securities decisions by the Seventh Circuit during the 1976-1977 term merit some discussion.

In Calvert Fire Insurance Co. v. Will,154 the Seventh Circuit granted a writ of mandamus requiring the district court to adjudicate rule 10b-5 claims despite the fact that an identical proceeding was pending in state court. Plaintiff Calvert alleged that defendant American Mutual Reinsurance Company had made misrepresentations and material omissions in connection with obtaining Calvert's participation in American's "multiple line pool" reinsurance program. On July 3, 1974, American Mutual sued Calvert in an Illinois court seeking a declaratory judgment that the pooling arrangement was in full force and effect. On January 10, 1975, Calvert answered alleging that the agreement was void due to violations of federal and state securities laws as well as common law fraud. Calvert also filed a counterclaim in state court for monetary damages based on all of the grounds asserted in its answer except the rule 10b-5 claims.

On the same day, Calvert also sued American Mutual in federal court, again seeking both rescission of the pooling agreement and monetary damages on the same grounds as those asserted in its answer and counterclaim in state court, except that Calvert also asserted a claim to monetary damages based upon rule 10b-5. American Mutual moved to abate the federal action pending resolution of the state court proceeding and, in the alternative, moved for dismissal on the ground that the reinsurance pooling arrangement did not constitute a security.

On May 6, 1975, the district court stayed all claims in Calvert's federal complaint except that for monetary damages based upon rule 10b-5.155 The court heard oral arguments on the issue of whether a participatory interest in the reinsurance pool constituted a security, but had not decided that issue as of the time of the court of appeals decision. In the meantime, the state trial court had decided that such participatory interests were not securities, and

153. 552 F.2d at 1250.
that holding had been affirmed by the Illinois Court of Appeals.\textsuperscript{156} Despite repeated motions by Calvert, the district court refused to reconsider its order staying the federal proceeding and refused to permit interlocutory review of that order. Accordingly, Calvert petitioned the Seventh Circuit for a writ of mandamus requiring the district court to adjudicate both the claim for equitable relief, \textit{i.e.}, rescission of the pooling agreement, and for damages under the 1934 Act and for an immediate decision with respect to the claim for damages.

After noting the extraordinary nature of the remedy of mandamus, the Seventh Circuit stressed that the district court had correctly relied upon the Seventh Circuit's opinion in \textit{Aetna State Bank v. Altheimer}.\textsuperscript{157} In \textit{Aetna}, the Seventh Circuit had affirmed the district court's stay of a federal action under rule 10b-5 in deference to state court proceedings involving the same transaction in which the identical 10b-5 claim was raised as an affirmative defense. The Seventh Circuit held, however, that in light of the Supreme Court's intervening decision in \textit{Colorado River Water Conservation District v. United States},\textsuperscript{158} the \textit{Aetna} decision no longer was good law, and, accordingly, it overruled that decision.

The \textit{Calvert} court interpreted the \textit{Colorado River} opinion as holding that:

> only in exceptional circumstances should a federal court dismiss an action because of the pendency of state proceedings involving the same issues. Circumstances which might lead to such a dismissal include: (1) the assumption of jurisdiction over a \textit{res} by the state court; (2) the desirability of avoiding piecemeal litigation; (3) the inconvenience of the Federal forum; (4) the order in which concurrent jurisdiction was obtained by the two forums.\textsuperscript{159}

The court noted that the Supreme Court had stated that "only the clearest of justifications will warrant dismissal."\textsuperscript{160} Judge Swygert observed that the district court had not dismissed Calvert's federal complaint but had merely stayed all of its claims except that for damages under rule 10b-5, which it had then refused to decide. This difference, the court ruled, was immaterial, and accordingly the \textit{Calvert} court held that a stay was only permissible under the "exceptional circumstances" test outlined in \textit{Colorado River}.\textsuperscript{161}

Judge Swygert found no such exceptional circumstances, relying most heavily on the fact that "the strong federal interest in the regulation of securities and the grant of exclusive jurisdiction in the federal courts to

\begin{itemize}
\item \textsuperscript{156} 560 F.2d at 794.
\item \textsuperscript{157} 430 F.2d 750 (7th Cir. 1970).
\item \textsuperscript{158} 424 U.S. 800 (1976).
\item \textsuperscript{159} 560 F.2d at 795.
\item \textsuperscript{160} 424 U.S. at 819.
\item \textsuperscript{161} 560 F.2d at 796.
\end{itemize}
judicature claims under the Securities Exchange Act of 1934 are compelling factors which weigh heavily against deference to state proceedings."\footnote{162} Accordingly, the Seventh Circuit ordered the district court "to proceed immediately with Calvert's claim for damages and equitable relief under the Securities Exchange Act of 1934."\footnote{163} 

In \textit{Glazer v. National Commodity Research and Statistical Service, Inc.},\footnote{164} plaintiff alleged that it and others had deposited funds with the defendant National Commodity Research and Statistical Service\footnote{165} for the purpose of purchasing options to purchase commodities futures contracts from it. Both "put" and "call" options were involved. Such options gave the plaintiffs the right to either purchase a commodities future contract from defendants or sell such commodities future contracts to defendants at a fixed price before a fixed date. Although the court did not mention the test propounded in \textit{SEC v. W.J. Howey Co.},\footnote{166} the Seventh Circuit held that there was no expectation of profits to be obtained from the efforts of others and that consequently the options were not "securities:'\footnote{167}

\begin{quote}
[P]rofit for a purchaser depends on the terms of the option, the amount of the premium [paid to NATCOM], the course of the market, and the purchaser's choice of the time to exercise the option. The profit does not depend on the efforts or skill of NATCOM. Exercise of an option would call upon NATCOM to produce and sell to the purchaser a specified commodity future contract, or to buy one from the purchaser, or, as the parties suggest, to settle in cash for the purchaser's profit. NATCOM's ability to perform would depend upon its financial resources.\footnote{167}

Curiously, the SEC in an amicus brief contended that the interests sold by NATCOM were securities, although admitting that the offer or sale of commodities, commodity futures, or bona fide options on commodity futures did not constitute the offer or sale of securities. The court quickly rejected this argument:

The foundation of the SEC position appears to be that because NATCOM represented itself to be a trader in commodity

\footnote{162} Id.
\footnote{163} Id. at 797. Although a majority of the judges of the Seventh Circuit did not favor a rehearing en banc when the opinion in \textit{Calvert} was circulated, Chief Judge Pell (for himself and Judges Fairchild, Tone and Bauer) filed a separate statement in which he expressed his preference for resolving the issues in \textit{Calvert} under a standard of whether the district court had abused its discretion in granting a stay of the federal litigation, rather than overruling the \textit{Aetna} decision. Judge Pell stated that he believed the Seventh Circuit had been led to the unfortunate conclusion of overruling \textit{Aetna} because of its unwillingness to consider Judge Will's stay an appealable order, despite applicable Seventh Circuit precedent holding such orders appealable. \textit{Id.} at 796 n.5.
\footnote{164} 547 F.2d 392 (7th Cir. 1977).
\footnote{165} Hereinafter referred to in the text as NATCOM.
\footnote{166} \textit{See} text accompanying notes 20-30 \textit{supra}.
\footnote{167} 547 F.2d at 393.
futures, and that representation was allegedly false, and because the extent to which NATCOM would be able to make good on its obligations would be limited by NATCOM’s success in making money out of other use of its resources, the purchasers actually bought an interest in the assets. Plaintiff may well be able to prove, under its complaint, that NATCOM’s false representations of ability to perform amounted to fraud. We are unable to perceive how the fact that the purchase of an option was fraudulently induced transforms the option into a security.168

In Emisco Industries, Inc. v. Pro’s, Inc.,169 plaintiff I.L. Grossman, Inc., purchased the assets of a division of defendant Pro’s, Inc., and in partial consideration therefor gave a five-year promissory note for $114,000. In their complaint, Grossman and its corporate parent asserted various misrepresentations in connection with the purchase of the division from defendant. In a motion to dismiss, defendant asserted that the promissory note was not a security and consequently there was no actionable claim under the anti-fraud provisions of the securities laws. Judge Swygert first observed that although the definition of the term “security” in the 1934 Act included “any note” other than a note with a maturity of nine months or less, “not all notes are securities within the meaning of the Act.”170

The Emisco court relied on the Supreme Court’s decision in United Housing Federation, Inc. v. Forman,171 stating that the Forman opinion “recognized that a distinction must be made between an investment transaction on the one hand and a commercial or consumer transaction on the other when construing the term ‘security.’ ”172 Under the “economic reality” test suggested by Forman and Howey,173 the Seventh Circuit held that defendant was not an investor with respect to the note given by plaintiff in exchange for the assets purchased. Judge Swygert stressed that the note was simply a “cash substitute” and was in the nature of a loan to plaintiff in order to finance the purchase of the assets.174 Moreover, there was clearly no reliance by defendant on plaintiff’s efforts to produce profits under the Howey and Forman rationale; defendant expected that the note would be paid regardless of whether plaintiff was able to operate on a profitable basis the division which it purchased.175

Plaintiffs also argued that they were investors with respect to the assets of defendant which they purchased. As Judge Swygert noted, however,

168. Id.
169. 543 F.2d 38 (7th Cir. 1977).
170. Id. at 39.
171. See text accompanying notes 27-28 supra.
172. 543 F.2d at 39.
173. See text accompanying notes 31-34 supra.
174. 543 F.2d at 41.
175. Id.
there was no reliance by plaintiff on "present and future efforts of another to produce profits." Indeed, plaintiff planned to itself take over the operations of the purchased division and whether or not it made a profit depended solely upon its own efforts.

Finally, in *Bender v. Crown*, the Seventh Circuit rejected what it termed a "bold and aggressive" attempt to collect legal fees. In *Bender*, the plaintiffs were attorneys who had represented opposing stockholders in a merger application filed with the SEC. As a result of these SEC proceedings, the merger application was abandoned and the minority stockholders were permitted to rescind the sale of their stock. Plaintiffs claimed that they were entitled to legal fees from the defendants in this case, who, although they were minority stockholders of the company, were not represented by plaintiffs in the proceedings before the SEC.

Plaintiffs had filed suit in New York, alleging a claim to compensation based upon the increase in value of the stock of the minority shareholders, whether or not they ever actually rescinded the sale of their stock. That action had been dismissed by the district court, and the dismissal affirmed on appeal to the Second Circuit. The Seventh Circuit adopted the Second Circuit's opinion, and added that the "private attorney general" concept was inapplicable to the facts of this case, citing the Supreme Court's decision in *Alyeska Pipeline Service Co. v. Wilderness Society* that "[c]ourts are not free to fashion drastic new rules with respect to the allowance of attorneys' fees to the prevailing party in federal litigation . . . ."  

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176. In a separate concurring opinion, Judge Cummings (the author of the opinion in *Daniel*) stated that if the seller of a business was relying on the purchaser's ability to conduct the business to insure repayment of the note, or if the purchaser had relied upon seller's representation as to the conduct of the business, the transaction could be held to have an "investment flavor." *Id.* (Cummings, J., concurring).
177. *Id.* at 41.
178. 551 F.2d 169 (7th Cir. 1977).
181. *Id.* at 269.