

## STATE AND FEDERAL COURT LITIGATION INVOLVING FUTURES AND DERIVATIVES

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### Introduction

This article discusses litigation in state or federal courts involving futures and futures derivatives. The purpose of this article is to compare the advantages and disadvantages of litigation in federal or state court with reparations proceedings under the Commodities Exchange Act<sup>1</sup> ("CEA" or the "Act"), and arbitration under the rules of futures exchanges or the National Futures Association ("NFA"). The first part of this article discusses the jurisdictional basis for litigation in state or federal courts and the substantive claims that may be filed in each of those forums. The article then discusses certain substantive law differences that should be considered in selecting a forum. In conclusion, the article discusses procedural and substantive advantages and disadvantages of proceeding in federal or state court as opposed to reparation proceedings or arbitration.

### Federal Courts

The Commodities Exchange Act in § 22(a)(1) provides a private right of action for violations of the Act. In pertinent part, § 22(a)(1) states as follows:

Any person (other than a contract market, clearing organization of a contract market, licensed board of trade, or registered futures association) who violates this Act or who willfully aids, abets, counsels, induces or procures the commission of a violation of this Act shall be liable for actual damages resulting from one or more of the transactions referred to in clauses (A) through (D) of this paragraph and caused by such violation to any other person -

- (A) who received trading advice from such person for a fee;
- (B) who made through such person any contract of sale of any commodity for future delivery (or option on such contract or any commodity); or who deposited with or paid to such person money, securities, or property (or incurred debt in lieu thereof) in connection with any order to make such contract;
- (C) who purchased from or sold to such person or placed through such person an order for the purchase or sale of -
  - (i) an option subject to section 4c of this Act (other than an option purchased or sold on a contract market or other board of trade);
  - (ii) a contract subject to section 19 of this Act; or
  - (iii) an interest or participation in a commodity pool; or
- (D) who purchased or sold a contract referred to in clause (B) hereof if the violation constitutes a manipulation of the price of any such contract.<sup>2</sup>

There are limitations on the private right of action provided by the Act. First, by its terms, § 22(a)(1) is limited to violations of the Act itself. There is a split of authority as to whether violations of CFTC rules also are actionable.<sup>3</sup>

Second, the section's remedy is limited to the types of transactions described in paragraphs (A) through (D) above and, accordingly, generally must involve at least one of the following:

1. the receipt of trading advice for a fee;
2. a transaction involving a futures contract, an options contract or the deposit of property in connection with an order for such a contract;

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3. an interest or participation in a commodity pool or certain over-the-counter options or leverage contracts; or
4. price manipulation of a futures or options contract.

Section 22(a) also provides a cause of action against "aiders and abettors" of CEA violations. Although § 22(a) imposes liability upon "[a]ny person...who violates this Act...", it limits secondary liability to one who "willfully aids and abets, counsels, induces or procures" a violation.<sup>4</sup> Courts have interpreted "willful" in the commodities context to mean that aiding and abetting liability requires some degree of knowing participation, and cannot be attributed exclusively to an employment or agency relationship.<sup>5</sup>

#### A. Federal Jurisdiction and Venue.

Section 22(c) of the Act limits jurisdiction over claims filed pursuant to the Act to the United States District Courts.<sup>6</sup> A claim may be brought "...in any judicial district wherein the defendant is found, resides or transacts business, or in the judicial district wherein any act or transaction constituting the violation occurs."<sup>7</sup> Service of process may be made "in any judicial district of which the defendant is an inhabitant or wherever the defendant may be found."<sup>8</sup>

At first blush, these two procedural aspects – broad venue and nationwide service of process – would appear to provide a substantial benefit to claimants. Yet, many futures customer agreements restrict venue and jurisdiction to the home city and state of the registered futures commission merchant, *i.e.*, frequently Chicago in the Northern District of Illinois. Courts have split as to whether such restrictions contravene the CEA venue and process provisions.<sup>9</sup>

#### B. Limitations.

Actions under Section 22 must be brought no later than two years after the date the cause of action arises.<sup>10</sup> Establishing when a claim "arises" varies with the fraudulent activity alleged. For example, in the case of unauthorized trading, the two-year period routinely begins to run when trading ceases in the account where the unauthorized trading allegedly occurred.<sup>11</sup>

Section 22 also appears to permit equitable tolling of claims. Originally, the Act contained no express private right of action. Accordingly, in considering private claims, courts borrowed analogous state or federal limitation periods,<sup>12</sup> and adopted federal tolling principles, holding that limitation periods do not begin to run until a party discovers or reasonably should have discovered the fraud.<sup>13</sup> Although the language of Section 22(c) does not expressly adopt federal equitable tolling principles, courts recently have routinely applied equitable tolling under such circumstances, as well as where there has been fraudulent concealment of claims.<sup>14</sup>

As with restrictions on venue, form customer agreements prepared by many futures commission merchants contain one-year contractual limitation provisions. Prior to the adoption of the two-year limitations period in the 1983 amendments to the CEA, courts had upheld these contractual limitations.<sup>15</sup> Decisions since the adoption of the two-year statutory limitation period have held that a contractual limitation on the statutory claim of less than two years is against public policy and unenforceable.<sup>16</sup>

#### C. Damages.

A successful litigant under Section 22(a) is entitled to damages equal to "...actual damages resulting from one or more of the [violative activities]..."<sup>17</sup> In cases of unauthorized trading and other fraudulent activities, courts have awarded damages equal to a party's "out-of-pocket" losses, including commission expenses.<sup>18</sup> In cases of churning, on the other hand, courts have limited damages to the amount of commissions, fees, interest and taxes paid by the plaintiff, and have not permitted recovery based upon change in portfolio value.<sup>19</sup> Because litigants are limited by the language of the Act to recovery of actual damages, they generally may not recover attorneys' fees or punitive damages.<sup>20</sup>

#### D. Related Federal and State Claims.

In proceeding under Section 22 of the Act, an aggrieved party may pursue relief under alternative federal and state claims. For example, federal commodities claims may be augmented by claims under the Racketeer Influenced and Corrupt Organization Act ("RICO").<sup>21</sup> Generally, RICO proscribes the conduct of an enterprise through a "pattern of racketeering" activity.<sup>22</sup> A "pattern" of

racketeering activities entails the commission of at least two "predicate acts" within a ten-year period.<sup>23</sup> The statute, which identifies certain specific activities as "predicate acts,"<sup>24</sup> does not specifically include commodities fraud.<sup>25</sup> Nonetheless, claimants have successfully alleged RICO violations arising out of commodities transactions by asserting the commission of mail or wire fraud violations as predicate acts.<sup>26</sup> RICO permits a person injured as a result of racketeering violations to recover treble damages plus reasonable attorneys' fees.<sup>27</sup>

State law claims may be appended to federal claims under §22(a)(1) in federal court under 28 U.S.C. §1367, and such claims frequently are very important in commodities litigation. For example, a plaintiff may assert common law causes of action for fraud, deceit, conversion, breach of fiduciary obligation and, importantly, breach of contract. In addition, a plaintiff may pursue relief under some state consumer statutes. *See, e.g.* Illinois Consumer Fraud Act, 815 ILCS 505/1 *et seq.*<sup>28</sup> The holdings in certain decisions in securities cases, however, suggest that not all state consumer fraud statutes provide a right of action for commodities law violations.<sup>29</sup>

One of the reasons that state law claims are so important in federal litigation is that they often permit the successful litigant to recover damages beyond those permitted by the Act. For example, under the Illinois Consumer Fraud Act, a successful litigant may recover its actual "economic" damages, plus costs, attorney's fees, and, in certain cases, punitive damages.<sup>30</sup>

### State Courts

While the CEA prohibits state regulation of the commodities markets, it does not preempt state common law causes of action.<sup>31</sup> As stated above, the federal right of action provided by § 22(a)(1) is not available in state court. Nonetheless, state substantive law remedies such as those referred to above may be pursued in state courts.

In practice, plaintiffs who elect to pursue commodities claims through the courts sometimes prefer state court to federal court. One major advantage of state court is a local forum. Access to a federal court may be difficult by reason of distance of the court from plaintiff. Other advantages of using state courts may include access to a local jury or a

local judge. Additional considerations may include cost -- in relationship to the size of the claim -- and the strength of the state law claim.

The primary disadvantage in selecting a state court forum is that the plaintiff gives up a federal right of action, albeit a relatively complex and detailed right of action. It should be noted that the jurisdictional and venue consents often contained in customer agreements may make it difficult to pursue a claim in state court.

### Substantive Law Considerations

In making a determination as to the forum in which to pursue a claim, a litigant should weigh a number of considerations. For example, as noted above, there is a split of authority as to whether a federal court under § 22(a)(1) will entertain a claim for violation of a CFTC rule. On the other hand, it is clear that in a reparations proceeding such a claim will be permitted.<sup>32</sup> As a practical matter, such a claim is always available in arbitration.

It appears to the authors, based on their experience, that the scienter requirement under the anti-fraud provisions of the CEA, §§ 4(b) and 4(o), is applied differently in federal court than in reparations proceedings or arbitration, although, technically, the standards should be the same. The federal courts require gross negligence or an intent to deceive and generally require a higher level of proof than is the case in CFTC reparations proceedings and in arbitrations.

Moreover, there also is a difference between how courts and reparations judges address the element of reliance. Under the rules of the CFTC, before opening a customer account, a futures commission merchant must provide a customer with a risk disclosure statement. The risk disclosure statement provides a signature line immediately below the following language: "I hereby acknowledge that I have reviewed and understand this risk disclosure statement." 17 CFR 1.55. Federal courts, in reviewing customer agreements and the signed risk disclosure statement, frequently find that an aggrieved customer did not "rely" on his/her broker's statements or omissions. By contrast, reparations judges or arbitration panels tend to view the risk disclosure statement with a more jaundiced eye, and generally are more sympathetic to a customer who disregards a

risk disclosure statement, especially if he or she was misled into signing it or given contrary oral assurances.

In addition, as stated above, claims in reparations proceedings may only be based upon a violation of the CEA or the CFTC rules and regulations. Administrative law judges may not consider claims arising under other federal laws, or under state law or common law.

Finally, a reparations proceeding provides a claimant with limited potential damages. Section 14(a)(1) of the Act generally limits awards in reparations proceedings to the "actual damages proximately caused by [the CEA] violation."<sup>33</sup>

#### Advantages and Disadvantages

Generally speaking, proceeding in court presents a litigant with numerous procedural advantages over reparations proceedings and arbitration. In all the federal district courts and most state courts, a claimant has a full range of disclosure or discovery available. In arbitration and in reparations, discovery is limited.

Discovery may be essential to a party who otherwise lacks access to the facts of the case. Many times discovery works to the defendant's advantage because of the plaintiff's admissions and activities at other firms. Conversely, a plaintiff may need the full range of discovery in order to obtain basic information about the activity in his/her account, the identity of third-party witnesses and documents in the control of non-parties.

Another advantage of court proceedings is the availability of motion practice. In court, both the plaintiff and defendant have a full range of motions available to dispose of the matter on substantive or procedural grounds. The ability to dispose of a reparations proceeding or arbitration short of a hearing is far more limited.

Moreover, a plaintiff in litigation can assert a full range of related claims, including claims under state law that may provide punitive damages, attorneys' fees or treble damages. As noted above, reparations proceedings are limited to statutory violations. Importantly, from a plaintiff's perspective, a right to a jury trial may be invaluable. Likewise,

the right to appeal the judge's decision is a significant right for both parties. Review of an arbitration award, on the other hand, is extremely limited.<sup>34</sup> Reparations decisions also have limitations on review.<sup>35</sup>

The principal disadvantage to both plaintiffs and defendants of proceeding in court is cost. Most customer's cases do not involve more than \$200,000 in damages. This factor often makes it very difficult for a plaintiff's lawyer who is handling a case on a contingency basis to pursue a case in court, because the cost of motions and discovery make it economically unfeasible. Although a defendant generally has the same costs as a plaintiff, it has those costs regardless of the size of the case, in most instances. Nevertheless, the defendant's costs in most litigation in court are substantially more than in arbitration or reparations because of motions and discovery.

Delay also may be a disadvantage for some claimants in federal or state court. In 1995, the median time for a case to go to trial in federal court was 18 months.<sup>36</sup> In larger districts, however, that time period may stretch to two years or more.<sup>37</sup> Time can be a major disadvantage or advantage in state court. In rural areas, state courts are generally current with their dockets and trial often will be forthcoming in less than a year. In major metropolitan areas, however, state courts may have backlogs stretching into multiple years. By contrast, most arbitration claims are concluded within a year. The NFA, the futures industry self-regulatory organization, reports that the average customer arbitration is concluded in 7.5 months.<sup>38</sup> The time for completing reparations proceedings, however, often exceeds that of federal or state court.

One of the major attractions to a plaintiff of proceeding in state or federal court -- the availability of a jury -- may also be a drawback. As a general proposition, federal and state court judges and juries have limited knowledge of the futures industry. This factor often necessitates the use of experts to educate the court and the jury, and substantively increases the time and cost of proceeding in court. More significantly, however, even the best expert can teach a jury only a limited amount about an extremely complex subject matter during the course of a trial. Proceeding in state or federal courts virtually assures that the trier of fact will be relatively inexperienced in the nuances of commodities law.

## Conclusion

In summary, federal and state courts may offer an attractive venue for a case where formal discovery or motions are important or where actual damages exceed \$500,000.00. Where a plaintiff's potential damages are significantly below that level, however, the disadvantages of proceeding in federal or state court generally outweigh the advantages that such forums provide. In such cases, arbitration or reparation proceedings may constitute the most desirable forum.

## ENDNOTES

<sup>1</sup> 7 U.S.C. § 1 *et seq.*

<sup>2</sup> 7 U.S.C. § 25(a)

<sup>3</sup> Compare In re ContiCommodity Services, Inc. Securities Litigation, 733 F. Supp. 1555, 1568, [1987-90 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶24,600 (N.D. Ill. Jan. 11, 1990) (CFTC rules not actionable), *rev'd in part*, Brown v. U.S., 976 F.2d 1104 (7<sup>th</sup> Cir. 1992), *aff'd in part*, ContiCommodity, Inc. v. Ragan, 63 F.3d 458 (5<sup>th</sup> Cir. 1995), *cert. denied*, 517 U.S. 1104 (1996); and Irvine v. Cargill Investor Services, Inc., 799 F.2d 1461, 1462 n.3 (11<sup>th</sup> Cir. 1986) (CFTC rules "probably" actionable).

<sup>4</sup> 7 U.S.C. § 25(a) (emphasis added).

<sup>5</sup> See Davis v. Coopers & Lybrand, 787 F.Supp. 787, [1990-92 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶25,249 (N.D. Ill. March 9, 1992).

<sup>6</sup> 7 U.S.C. § 25(c).

<sup>7</sup> Id.

<sup>8</sup> 7 U.S.C. § 25(c).

<sup>9</sup> See, e.g., Berman v. Zapata Offshore Co., 407 U.S. 1 (1972); Heinold Commodities Inc. v. Hager, [1980-

82 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶21,287 (N.D. Ill. May 30, 1981).

<sup>10</sup> 7 U.S.C. § 25(c).

<sup>11</sup> Federal Deposit Ins. Corp. v. UMIC, Inc., 136 F.3d 1375, Comm. Fut. L. Rep. (CCH) ¶27,232 (10<sup>th</sup> Cir. Feb. 18, 1998); Indemnified Capital Invs. v. R.J. O'Brien & Assocs., 12 F.3d 1406, 1411 (7<sup>th</sup> Cir. 1993).

<sup>12</sup> See, e.g., Cange v. Stotler & Co., 826 F.2d 581 (7<sup>th</sup> Cir. 1987) ("Cange I").

<sup>13</sup> Cange I, 826 F.2d at 586-87.

<sup>14</sup> See Dyer v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 928 F.2d 238, 240 (7<sup>th</sup> Cir. 1991) (two-year statute of limitations begins to run when plaintiff, in the exercise of due diligence, has constructive knowledge of the conduct in question); Benfield v. Mocatta Metals Corp., 26 F.3d 19, 22 (2<sup>d</sup> Cir. 1994).

<sup>15</sup> See Cange I, 826 F.2d at 586-87.

<sup>16</sup> See, e.g., Madero v. Refco, Inc., 934 F. Supp. 282, [Current] Comm. Fut. L. Rep. ¶26,901 (N.D. Ill. July 23, 1996).

<sup>17</sup> 7 U.S.C. § 25(a)(1).

<sup>18</sup> See, e.g., In re ContiCommodity Services, Inc., *supra*, 733 F. Supp. at 1564-65.

<sup>19</sup> See, e.g., McBain v. Jack Carl Assocs., 705 F. Supp. 1340, 1344 (N.D. Ill. 1989).

<sup>20</sup> 7 U.S.C. § 25(a)(1).

<sup>21</sup> 18 U.S.C. §§ 1961-68.

<sup>22</sup> 18 U.S.C. § 1961; Sedima S.P.R.L. v. Imrex Co., 473 U.S. 479, 496 (1985).

<sup>23</sup> 18 U.S.C. § 1961 (4).

<sup>24</sup> See 18 U.S.C. § 1961(4).

<sup>25</sup> In 1995, Congress passed the Securities Reform Act of 1995, which substantially limits the applicability of RICO to securities law violations. Under the Reform Act, fraud in the sale or purchase of a security is not a "predicate act" under RICO, unless the defendant actually is convicted of a criminal securities fraud violation. 18 U.S.C. § 1961(4); Pub-L 104-67 § 107 (1995). Commodities fraud was not similarly restricted by that legislation.

<sup>26</sup> See, e.g., Evanston Bank v. ContiCommodity Services, 623 F.Supp. 1014, 1025 (N.D. Ill 1985).

<sup>27</sup> 18 U.S.C. § 1964(c).

<sup>28</sup> In the Matter of Lake States Commodities, Inc., 936 F. Supp. 1461, 1478 (N.D. Ill. 1996) (holding FCM liable for violations of Illinois Consumer Fraud Act).

<sup>29</sup> Cf. Seeman v. Arthur Andersen & Co., 896 F. Supp. 250 (D. Conn. 1995) (Connecticut Unfair Trade Practices Act does not apply to sale of security); Morris v. Gilbert, 649 F. Supp. 1491, 1497. (E.D. N.Y. 1986) (New York's deceptive practices act, Gen. Bus. Law § 349, does not apply to securities transactions).

<sup>30</sup> See 815 ILCS 505/10(a).

<sup>31</sup> See American Agric. Movement, Inc., v. Board of Trade of the City of Chicago, 977 F.2d 1147, 1156-57 (7<sup>th</sup> Cir. 1992) (application of state law that does not affect operation of futures markets and deals only with

relationship between broker and other individuals not preempted); Farmers Co-Op Elevator, Woden, Iowa v. Doden, 946 F. Supp. 718, 729 n.4 (N.D. Iowa 1996); Khalid Bin Talal Bin Abdul Azaiz al Seoud v. E.F. Hutton & Co., 720 F. Supp. 671, 676 [1987-90 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶24,572 (N.D. Ill. Aug. 24, 1989).

<sup>32</sup> 7 U.S.C. § 17(a)(1) (providing jurisdiction with respect to violations of "any provision of this Act or any rule, regulation, or order issued pursuant to this Act..."); Abeyata v. Bear, Stearns & Co., [1980-82 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶21,350 (CFTC Feb. 10, 1982).

<sup>33</sup> 7 U.S.C. § 17(a)(1).

<sup>34</sup> See Federal Arbitration Act, 9 U.S.C. §§ 9, 10; Wilko v. Swan, 346 U.S. 427, 436-37 (1953).

<sup>35</sup> 17 CFR Part 12, Subpart F.

<sup>36</sup> Administrative Office of the United States Courts, Judicial Business of the United States Courts: 1995 Report of the Director, Table C-5, pp. 168-170 (1995).

<sup>37</sup> Id.

<sup>38</sup> See K. Camp and C. Cain, Current Issues in NFA Arbitration 6 (1997).