



News & Types: Commercial, Competition & Trade Update

Fraudster's "Blame the Victim" Defense Fails

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Richard Carter was a rancher in Wyoming where he operated a family-owned cattle ranch. He had the misfortune of using a dishonest broker who cost him a lot of money. Efforts to blame Mr. Carter for the loss were not successful and the broker, and his employer, ended up with a multi-million dollar judgment against them. (*Straits Financial LLC v. Ten Sleep Cattle Company and Richard Carter No. 16-3860 and Ten Sleep Cattle Company and Richard Carter v. Straits Financial LLC and Jason Perkins*, Nos. 16-3903, 16-3967, and 17-2100, 7th Circuit Court of Appeals, August 13, 2018)

In March 2010, Carter opened a commodities futures and options trading account (referred to in the opinion as the "33 Account", the last two digits of the account number) through the broker, Jason Perkins, who was at the time employed by R.J. O'Brien (RJO). The goal was to protect against losses by locking in the price Ten Sleep, Carter's ranch, would receive for its cattle. The intention was to reduce risk. At the time, Carter signed several documents and agreements with RJO, including an Account Agreement. The Account Agreement contained a personal guarantee that required Carter to assume any debts owed by Ten Sleep to RJO. The Account Agreement also permitted RJO to use any account balances or deposits to offset any losses and expenses. RJO reserved the right to assign the account to another registered futures commission merchant. Since RJO is based in Chicago, the Account Agreement applied Illinois law and provided for Illinois as the dispute resolution forum.

In April 2011, Perkins moved his brokerage to Straits Financial, where he became an employee and manager of a branch office. As part of the move, Carter and other customers of Perkins received a "negative consent letter", notifying them that their accounts would be transferred unless they objected. Carter did not object. So Straits Financial took control of the 33 Account using the RJO Account Agreement that contained Carter's personal guarantee. Carter did not sign any documents or agreements directly with Straits Financial.

In May 2011, Perkins had an idea. He proposed to Carter to open a speculative trading account with Straits Financial that would give him discretion to invest Carter's money without prior authorization. Perkins and Carter would split the profits fifty-fifty. Carter agreed. There were no written authorizations and contracts to document this agreement, except for Carter's signature on Straits Financial's one-page Related Account Authorization form that indicated the new account was merely for "Record Keeping Purposes." Perkins did not tell Carter at the time, but later admitted, that this arrangement violated Straits Financial's policies and commodities industry rules. This account was referred to in the opinion as the "35 Account."

Judge Hamilton, writing the opinion, noted, “One might guess what happened next.” By mid-March 2012, the 35 Account had profits, actually good-size profits of \$300,000. Carter gave clear instructions to Perkins: “send the \$300,000 [cumulative profit] to me”, “I will send your half back” [which he did], and “close it [the 35 Account] out, don’t do anything more . . . Shut it down and don’t do anything more.”

But Perkins failed to follow Carter’s instructions. He continued to speculate in Treasury Bond futures, without Carter’s knowledge. By mid-June 2012, the losses exceeded \$2 million. Carter’s first knowledge of any problem was when he tried to cash out of a large position in the 33 Account and did not receive a response. Around June 20, Perkins admitted to Carter, “we kinda have a problem . . . they’re holding your account money in your livestock account to clear this up.” What Perkins meant was that Straits Financial was holding the 33 Account to offset the \$2 million shortfall in the 35 Account. To do this, Straits Financial used the authorization in the RJO Account Agreement.

Judge Hamilton noted two reasons why Carter was unaware of the losses accumulating in the 35 Account. Ten Sleep had been depositing funds in the 33 Account so those funds were “cross-margined” with the 35 Account. Said Judge Hamilton, “This meant that while Carter wired well over a million dollars into his hedging account at Straits Financial [the 33 Account] between March and June 2012 in response to Perkins’s requests, Carter did not know that these cash infusions into the 33 Account actually served to stave off the closure of both accounts as Perkins’s trades kept digging the 35 Account into a deeper hole.”

The second reason is that these financial shenanigans coincided with calving season. So Carter was away from Ten Sleep and did not see his monthly statements that would have showed him what was happening to his accounts. During this time, Perkins used Carter’s inaccessibility to reassure his bosses at Straits Financial, claiming Carter would call him back and “Don’t worry we will be fine [Carter] is just moving some stuff around in the fields.”

Perkins eventually admitted to Carter what had been happening. They met at Carter’s lawyer’s office in Casper, Wyoming. Perkins acknowledged that Straits Financial would not send the balance of the 33 Account that was being used to offset the losses in the 35 Account. During the meeting, Perkins signed an affidavit admitting that he conducted “account activity on numerous occasions without consulting” Carter. Perkins returned home, retained counsel, resigned from Straits Financial, and moved his brokerage to another firm.

Oddly, the litigation was started by Straits Financial. Straits Financial liquidated the 33 Account worth \$1,823,168.77, applied the proceeds to offset the deficiency of \$1,992,045.79 in the 35 Account and sued Ten Sleep and Carter for the deficiency of \$168,877.02. Carter and Ten Sleep moved the case to federal court in Chicago.

Carter took the obvious step of filing a counterclaim against Straits Financial and Perkins based on, among other claims, conversion, fraud, breach of fiduciary duty and violation of the Illinois Consumer Fraud and Deceptive Business Practices Act (ICFA). Significantly, the ICFA permitted a successful claimant to recover attorneys’ fees. Carter and Ten Sleep also claimed Straits Financial had negligently supervised Perkins.

In a seven-day bench trial before the district judge, Carter and Ten Sleep mostly won. The judge determined that Perkins had defrauded Carter, that Straits Financial was vicariously liable for the fraud and for violation of

the ICFA (and, therefore, for Carter's attorneys' fees) and that Carter had also proven that Straits Financial had been unjustly enriched by Perkins's fraud and converted Carter's money to its own benefit. The district judge refused to enforce Carter's personal guarantee that was part of the RJO Account Agreement.

But Straits Financial did get one benefit. Remember all those monthly statements that piled up while Carter was away during calving season? The judge decided that Carter should have learned of the losses by June 11, 2012. So Straits Financial was not responsible for losses between June 11 and June 20. Ten Sleep's recovery was reduced from \$2,206,754.80 to \$1,457,601.50. Both sides appealed.

In its appeal, Straits Financial did not contest that Perkins committed fraud or that, as his employer, Straits Financial was vicariously liable. But Straits Financial thought that it should get the benefit of the Account Agreement that Carter originally signed with RJO. As mentioned, the Account Agreement (a) included Carter's personal guarantee and (b) permitted RJO (and Straits Financial) to offset losses and expenses.

Judge Hamilton did not agree. Judge Hamilton acknowledged that courts in Illinois (the governing law) will enforce an assignment even if the "party whose obligations were assigned" did not receive notice of the transaction. On the other hand, Illinois courts will construe guaranties strictly in favor of the guarantor and not in favor of the beneficiary. "A guarantor has acquired status as a favorite of the law, and when construing liability the court accords the guarantor the benefit of any doubts that may arise from the language of the contract." A guarantor can be discharged from liability when there has been a material change in the business dealings between the parties.

Here, Judge Hamilton agreed with the district judge that there was a material change. A non-discretionary account to protect against price fluctuations morphed into an account under which Perkins, without authorization or knowledge of Carter or Ten Sleep, speculated on Treasury Bond futures. Straits Financial's losses resulting from Perkins's fraud could not be covered by the personal guarantee of Carter, the victim of the fraud. (For another case, in which the personal guarantee was construed strictly in favor of the guarantor, see our article at: <https://www.masudafunai.com/articles/former-nba-star-has-to-take-his-game-to-another-level-appeals-court-refuses-to-enforce-nba-stars-personal-guaranty>.)

Straits Financial also piggybacked on the district judge's conclusion that Carter failed to mitigate its damages from June 11 to June 20. Why shouldn't Carter be responsible for reviewing his statements when he received them? By not reviewing his statements and not objecting to the trades, Carter ratified them, claimed Straits Financial. Here also, Straits Financial used the RJO Account Agreement, which required the customer to promptly report unauthorized trades or else be responsible for the losses.

But this was a fraud case. A victim of a fraud should act promptly after learning of the fraud, which Carter did. Illinois courts have rejected "strict formalism" in cases of fraud. They reject "a result . . . contrary to the established principle that a party committing fraud should be precluded from benefiting therefrom." Judge Hamilton agreed. Rather than imputed knowledge based on the statements that Carter did not review, Carter's actual knowledge was critical. Upon receiving actual knowledge of the unauthorized trades, Carter acted promptly.

Straits Financial ended up being hoisted on its own petard. It unsuccessfully argued that Carter's failure to object to the trades at a much earlier point precluded Carter's claim. The district judge agreed, but only after June 11. So the district judge reduced Ten Sleep's damages by \$749,153.30. Of course, Carter and Ten Sleep appealed this finding.

Judge Hamilton found the reduction to be unjustified.

"Fraud victims are not responsible for their agent's fraud before they even learn of any unauthorized activity. . . . Under Illinois law, the injured party must have actual knowledge of the problem before it must act to mitigate its damages.

"The duty to mitigate damages does not arise until the injured party has actual knowledge of the injury. In other words, fraud victims are expected to take reasonable action once they are made aware of the real situation. But fraud victims will not lose the benefit of later remedies simply because better precautions on their part might have avoided the fraud or ended it sooner, which is often the case, especially with a court's benefit of hindsight. [Quoting a treatise on tort law] 'Contributory negligence is not a defense to an intentional or reckless tort.'"

So Judge Hamilton sent the case back to the district judge with regard to the \$749,153.30 reduction in damages for failure to mitigate, obviously intending that Carter and Ten Sleep would probably be entitled to this amount also.

The fact that the case was a fraud claim was crucial to the result. Straits Financial had some good arguments. Carter did personally guarantee the losses on the account. Carter had failed to review the statements for several months.

But, as the court noted, guarantors are favorites of the law. And fraud victims will still be protected even in the face of alleged negligence.