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The Inconspicuous Effect of Insider Trading - Convertible Securities and Corporate Reorganizations

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The Inconspicuous Effect of Insider Trading — Convertible Securities and Corporate Reorganizations

In response to abusive securities practices, Congress enacted the Securities Exchange Act of 1934.[1] The primary purpose of the Act, established in section 2,[2] is to insure a fair and honest market that will reflect an evaluation of securities in the light of all available and pertinent data. In keeping with this primary purpose, the Act includes section 16(b),[3] which essentially provides that any profit realized within any six months period by a beneficial owner, director, or officer of a corporation, resulting from a purchase and sale or a sale and purchase of the equity securities of the corporation, shall be paid to the corporation. This comment will explore the inconspicuous, or nonapparent, effects of section 16(b) on transactions involving convertible securities and corporate reorganizations. The use of convertible securities and the existence of corporate reorganizations are every day affairs in the airline industry, as well as other industries.

I. History

Because of divergent directions taken by the courts in their interpretation of section 16(b) subsequent to its enactment, a survey of its common law background and legislative history is in order. Prior to passage of the Act, corporate insiders[4] with advance information about their corporations were able to reap enormous profits by buying and selling their corporation's securities at the expense of stockholders who bought and sold without such inside information.[5] At common law the less knowledgable stockholder

[1] Securities Exchange Act of 1934, 48 Stat. 881 (1934), 15 U.S.C. § 78 (1964).

[2] 48 Stat. 881 (1934), 15 U.S.C. § 78b (1964).

[3] For the purpose of preventing the unfair use of information which may have been obtained by such beneficial owner, director, or officer by reason of his relationship to the issuer, any profit realized by him from any purchase and sale, or any sale and purchase, of any equity security of such issuer (other than an exempted security) within any period of less than six months, unless such security was acquired in good faith in connection with a debt previously contracted, shall inure to and be recoverable by the issuer, irrespective of any intention on the part of such beneficial owner, director, or officer in entering into such transaction of holding the security purchased or of not repurchasing the security sold for a period exceeding six months. Suit to recover such profit may be instituted at law or in equity in any court of competent jurisdiction by the issuer, or by the owner of any security of the issuer in the name and in behalf of the issuer if the issuer shall fail or refuse to bring such suit within sixty days after request or shall fail diligently to prosecute the same thereafter; but no such suit shall be brought more than two years after the date such profit was realized. This subsection shall not be construed to cover any transaction where such beneficial owner was not such both at the time of the purchase and sale, or the sale and purchase, of the security involved, or any transaction or transactions which the Commission by rules and regulations may exempt as not comprehended within the purpose of this subsection. Securities Exchange Act 16(b), 48 Stat. 896 (1934), 15 U.S.C. § 78p(b) (1964).

[4] Section 16(a) defines "insider" in the following manner: "Every person who is directly or indirectly the beneficial owner of more than ten per centum of any class of any equity security (other than an exempted security) which is registered . . . on a national securities exchange or who is a director or an officer of the issuer of such security . . . ." 48 Stat. 896 (1934), 15 U.S.C. § 78p(a) (1964).

[5] *See* S. Rep. No. 1455, 73d Cong., 2nd Sess., 32-33, 47 (1934); S. Rep. No. 792, 73d Cong., 2d Sess. 9 (1934).

lacked adequate protection from this unfair practice. The majority rule was that an officer or director ". . . does not sustain a fiduciary relation to an individual stockholder with respect to his stock and that . . . the mere failure on . . . [his] part . . . to disclose inside information will not militate against him so long as he does not actively mislead the seller or perpetrate a fraud."[6] The minority view, however, stated that "directors and officers stand in a fiduciary relationship to the stockholders of the corporation and that this prevents their trading at arm's length with any stockholder and requires a full disclosure of all material facts affecting the value of the shares."[7]

In order to provide the remedy which the common law did not, section 16(b) was incorporated into the Act. The section was "designed to protect the 'outside' stockholder against at least short-swing speculation by insiders with advance information."[8] The Congressional hearings established the intent of the legislature to rest liability on an objective standard of proof. The chief spokesman for the draftsmen, testified:

> You hold the director, irrespective of any intention or expectation to sell the security within six months after, because it will be absolutely impossible to prove the existence of such intention or expectation, and you have to have this crude rule of thumb, because you cannot undertake the burden of having to prove that the director intended, at the time he bought, to get out on a short-swing.[9]

He testified further that if the director had to sell, "Let him get out what he put in, but give the corporation the profit."[10]

The potential effectiveness of the statute is very questionable. If the insider has information suggesting good prospects for the corporation, he can avoid section 16(b) entirely by buying stock, holding it for six months, and then selling.[11] If his information indicates a poor corporate performance, he can avoid the section by selling stock, waiting for at least six months and then buying the stock back at a more favorable time.

Enacted as a counterpart of section 16(b) was section 16(a)[12] requiring insiders to report regularly their holdings and transactions in securities of the issuer. Further, the coverage of section 16(b) was extended by section 12(g)(1) to include, as well as listed companies, large over-the-counter companies engaged in interstate commerce or in a business affecting interstate commerce.[13] In the ordinary situation involving a purchase

[6] Yourd, *Trading In Securities By Directors, Officers and Stockholders; Section 16 of The Securities Exchange Act*, 38 MICH. L. REV. 133, 139, & n.27 (1939).

[7] *Id.* at 140 & nn.29 & 30. There was a "special circumstances" doctrine announced by *Strong v. Repide*, 213 U.S. 419 (1909) whereby recovery would be permitted if all the circumstances indicated that the insider had taken an inequitable advantage of a stockholder.

[8] Smolowe v. Delendo Corp., 136 F.2d 231, 235 (2d Cir. 1943).

[9] *Hearings on S. Res. 84, 56, 97, Before the Comm. on Banking and Currency*, 73d Cong., 2d Sess. 6557 (1933).

[10] *Id.*

[11] Note that this action will further benefit him by affording him capital gain taxation treatment on the sale. *See* INT. REV. CODE of 1954, § 1222.

[12] 48 Stat. 896 (1934), 15 U.S.C. § 78p(a) (1964).

[13] 78 Stat. 566 (1934), 15 U.S.C. § 78(l)(g)(1) (1964). This statute requires registration by an issuer having total assets of over $1,000,000 of each class of equity security held of record by 500 or more persons. Additionally, the issuer must be engaged in interstate commerce, or in a busi-

and sale or a sale and purchase for cash, the application of the statute is exact and straight forward; however, like most statutes there are interpretations which must be made by the courts. Most of these interpretations have been concerned with such subjects as computation of dividends in determining realized profits,[14] measurement of the six-month period,[15] necessity of being a director at the time of purchase and sale,[16] tolling of the two year statute of limitations,[17] employees deemed officers,[18] settlement,[19] and interpretation of exceptions.[20] Since the business world today enjoys the use of elaborate methods and sophisticated instruments of finance, these methods and instruments have created for the courts their major interpretive problems under section 16(b). As we shall see, many of the problems concern the "purchase and sale" issue.

The leading case of *Smolowe v. Delendo Corp.*[21] upheld the constitutionality of section 16(b). This was an action against the defendants, who were both directors and president and vice-president, respectively, of Delendo Corporation, for profits realized from buying and selling the stock during a six month period. The opinion of the Second Circuit laid down precedents still adhered to by the courts in dealing with section 16(b). A subjective standard of proof was rejected as such would "torture the conditional 'may' in the preamble into a conclusive 'shall have' or 'has',"[22] and an objective standard was approved. As to computation of profits, the established income tax rule which first looks to the identification of the stock certificate and then applies "first in, first out"[23] was rejected because under it, corporate insiders could exempt themselves from statutory liability by maintaining a supply of stock certificates and carefully selecting those to deliver. The harshness of section 16(b) is exhibited by the court's announcement that the proper accounting method is "lowest price in, highest price out"[24] within six months. The court stated the purpose of the Act in language which has often been quoted:

> We must suppose that the statute was intended to be thorough-going, to squeeze all possible profits out of stock transactions, and thus to establish a standard so high as to prevent any conflict between the selfish interest of a fiduciary officer, director, or stockholder, and the faithful performance of his duty.[25]

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ness affecting interstate commerce, or have its securities traded through the mails or through interstate commerce.

[14] Western Auto Supply Co. v. Gamble Skogmo, Inc., 348 F.2d 736 (8th Cir. 1965), *cert. denied*, 382 U.S. 987 (1966); Adler v. Klawns, 267 F.2d 840 (2d Cir. 1959).

[15] Stella v. Graham-Paige Motors Corp., 104 F. Supp. 957 (S.D.N.Y. 1952).

[16] Adler v. Klawns, 267 F.2d 840 (2d Cir. 1959); Blau v. Allen, 163 F. Supp. 702 (S.D.N.Y. 1958).

[17] Blau v. Albert, 157 F. Supp. 816 (S.D.N.Y. 1957).

[18] *See* Rule 36-2 (17 C.F.R. § 240.3b-2 (1966)) under Exchange Art.; Lockheed Aircraft Corp. v. Campbell, 10 F. Supp. 282 (S.D. Cal. 1953).

[19] Blau v. Hodgkinson, 100 F. Supp. 361 (S.D.N.Y. 1951).

[20] Booth v. Varian Associates, 334 F.2d 1 (1st Cir. 1964); Stella v. Graham-Paige Motors Corp., 104 F. Supp. 957 (S.D.N.Y. 1952).

[21] 136 F.2d 231 (2d Cir.), *cert. denied*, 320 U.S. 731 (1943).

[22] *Id.* at 236.

[23] 26 C.F.R. § 1.1012-1 (1969).

[24] *Id.* at 239.

[25] *Id.*

The inconspicuousness and harshness of the statute is indicated by the following hypothetical examples which illustrate the proper accounting method for profits under the statute. "A" is an insider of corporation "X." "A" buys stock for $10 on 1 January, sells stock for $20 on 1 February, buys stock for $30 on 1 March and sells stock for $40 on 1 April. "A" has realized a net profit of $20 on this series of transactions; however, applying "lowest price in, highest price out," he had a profit of $30 which he must pay to "X." In the second example, "A" buys stock for $10 on 1 January, sells stock for $30 on 1 February, buys stock for $40 on 1 March and sells stock for $10 on 1 April. "A" has realized a net loss of $10 on this series of transactions, but as interpreted by the statute he had a profit of $20 which he must pay to "X."

The "lowest price in, highest price out" interpretation merits criticism because the courts are incorrectly construing the statute as a penalty statute. The drafters seem not to have intended it as a penalty statute,[26] and the statute itself clearly says "any profit realized."

II. CONVERTIBLE SECURITIES

In *Park & Tilford v. Schulte*,[27] the Second Circuit reaffirmed its objective rule of thumb approach announced in *Smolowe*. The defendants were three brothers who owned a majority of the common, voting stock in plaintiff corporation and also held its redeemable, convertible preferred stock. The corporation called the preferred stock for redemption because of a rise in the market price of its common stock, and the defendants elected to convert their preferred stock into common, then sold at a profit within six months. The issue before the court was whether the conversion of preferred stock into common was a purchase. The court found a purchase and held the defendants liable in that they "did not own the common stock in question before they exercised their option to convert; they did afterward."[28] Noting that the defendants in their controlling position could have thwarted the redemption, the court decided that the decision to convert was an everyday business decision and not a forced conversion. The court relied on section 3(a)(13)[29] of the Exchange Act, defining a purchase as "any contract to buy, purchase, or otherwise acquire," to state broadly that a conversion of preferred into common stock followed by a sale within six months constitutes a purchase and sale.

The next litigation involving a conversion was *Ferraiolo v. Newman*.[30] As a result of a merger the defendant acquired convertible preferred stock of Ashland Oil & Refining Company and became an inactive director. Over three years later and in response to the preferred stock being called for redemption, he converted his shares into common stock, then within six months sold a substantial portion of that common stock. The Sixth

[26] H.R. Doc. No. 7852 and S. Doc. No. 2693, 73d Cong., 2d Sess. (1934).
[27] 160 F.2d 984 (2d Cir.), *cert. denied*, 332 U.S. 761 (1947).
[28] *Id.* at 987.
[29] 48 Stat. 882 (1934), 15 U.S.C. § 78c(13) (1964).
[30] 259 F.2d 342 (6th Cir. 1958), *cert. denied*, 359 U.S. 927 (1959).

Circuit found the preferred and common stock "economic equivalents"[31] in that the preferred, which had an anti-dilution provision,[32] and the common were selling at equivalent prices. The court rejected the rule of thumb approach and adopted a pragmatic approach; the transaction "created no opportunity for profit which had not existed since 1948 . . . [and] . . . was not one that could have lent itself to the practices which section 16(b) was enacted to prevent."[33] *Park & Tilford* was distinguished from this case both because there the exchange of nonmarketable preferred for more valuable marketable common and the absence of dilution protection rendered the two classes of stock far from economic equivalents and also because the conversion "was voluntary in that the insiders had complete control of the corporation and could, therefore, determine whether the preferred would be called for redemption."[34] *Ferraiolo* has been criticized and applauded, but it stands as the initial step taken by the federal courts in a long line of decisions which appear to overlook the real intent of the drafters to deter insider abuse in favor of a case by case evaluation of whether the particular transaction permits such insider abuse.

The pragmatic approach was followed in the Ninth Circuit in *Blau v. Max Factor & Co.*[35] The corporation's stock consisted of common stock owned by members of the Max Factor family and Class A stock owned by the general public. The two classes were identical except that the directors possessed the power to declare a lesser dividend on the common stock, and the common stock was convertible into Class A stock. When members of the family converted common into Class A stock and sold within six months, the conversion was held not to be a purchase. The court found the defendants "made only one investment decision in the six months' period—the decision to terminate their long-term investment by sale. The exchange was in reality only a step in the process of sale—and an unnecessary one at that, for Common was as marketable as Class A and at precisely the same price."[36]

The two fairly recent opinions in *Heli-Coil v. Webster*[37] and *Blau v. Lamb*[38] emphasize the conflict between jurisdictions on application of section 16(b). *Heli-Coil* was a Third Circuit case in which the corporation sued one of its directors for short-swing profits. In November 1958, the defendant bought debentures convertible into common stock; in March 1959, he elected to convert; and in July, August, and September 1959, he sold common stock. The court considered two possible grounds of liability: (1) Whether the conversion constituted a sale of debentures and (2) whether it constituted a purchase of common stock. The court

[31] *Id.* at 345.
[32] This provision provided that if there was a change in the amount of common stock outstanding the conversion ratio would be adjusted proportionately.
[33] 259 F.2d at 346.
[34] *Id.*
[35] 342 F.2d 304 (9th Cir. 1965).
[36] *Id.* at 308.
[37] 352 F.2d 156 (3d Cir. 1965).
[38] 363 F.2d 507 (2d Cir. 1966), *cert. denied*, 385 U.S. 1002 (1967).

found affirmatively on both, but absolved the defendant from liability on the sale as the paper profit was not realized. In holding the conversion a purchase and the defendant liable, the court noted the two roads taken in earlier cases and followed *Park & Tilford* by saying "it was the intention of Congress in enacting 16(b) to obviate any necessity for a search of motives of the insider or require an investigation of whether or not his actions were animated by inside information to gain a speculative profit."[39] The court recognized the argument that the preamble of the statute is operative rather than descriptive, thus requiring a subjective intent; but it supported its objective test by pointing out that the SEC is authorized, under section 16(b), to exempt by rules any transaction deemed "not comprehended within the purpose of this subsection."[40] Thus Congress has delegated to the SEC, rather than to the courts, the task of determining circumstances justifying exemption of certain transactions. It has been suggested that the securities in this case were arguably "economic equivalents."[41] Based on past decisions, a finding of "economic equivalents" would justify no liability, but it would seem that the court correctly followed the approach which adopts the intent of the drafters.

In *Blau v. Lamb*, which involved several security transactions, the primary concern is with the conversion by a principal shareholder of convertible preferred stock received incident to a merger into common stock. The Second Circuit Court of Appeals was concerned with whether the conversion was a sale, the lower court having already found a purchaser.[42] It is significant that this court refused to follow its *Park & Tilford* objective approach and "in order to avoid 'purposeless harshness' "[43] adhered to the pragmatic approach of *Ferraiolo*. Based upon "economic equivalence"[44] and "unchanged investment position"[45] the court found no possibility for insider speculation and thus no sale. The court was careful to apply economic equivalence only to the facts of this case and to state that economic equivalence applies only when the convertible security is traded at a price equivalent to the aggregate price of the securities into which it was convertible.[46]

In the recent case of *Newmark v. RKO General, Inc.*,[47] involving an airline merger, a district court in the Second Circuit leaned heavily on the pragmatic approach. The case appears to be the most recent adjudication on application of section 16(b) to convertible security transactions. In May 1967 RKO contracted with Central Airline security holders to purchase 49 percent of Central's outstanding shares and $500,000 face amount of Central convertible debentures. The shareholders promised to vote in favor of a merger between Central and Frontier Airlines, such merger

[39] 352 F.2d at 165.
[40] 48 Stat. 896 (1934), 15 U.S.C. § 78p(b) (1964).
[41] W. PAINTER, FEDERAL REGULATION OF INSIDER TRADING (1968).
[42] 242 F. Supp. 151, 155 (S.D.N.Y. 1965).
[43] 363 F.2d at 519.
[44] *Id.* at 522.
[45] *Id.*
[46] *Id.* at 524, 525.
[47] 294 F. Supp. 358 (S.D.N.Y. 1968).

having been negotiated by RKO which owned 56 percent of Frontier. The merger received the necessary shareholder and CAB approval and on 1 October 1967, RKO exchanged Central common and convertible debentures for Central-Frontier common and convertible debentures. The section 16(b) claim was brought on behalf of Central-Frontier for short-swing profits realized by RKO.

In asserting its first "no sale" argument, RKO relied on a host of cases[48] to argue that the Central convertible debentures were economically equivalent to the Central-Frontier common. Citing *Blau v. Lamb*,[49] the court held that the securities of two different issuers are not economic equivalents and held a 49 percent ownership of Central common is not equivalent to a 20-25 percent ownership of Central-Frontier.

In RKO's second "no sale" argument, it argued that the pragmatic approach should be extended beyond economic equivalency situations, as here where RKO was "locked into" the merger at a 1 for 3½ ratio and could not abuse its insider position. They relied on two Second Circuit cases: *Blau v. Ogsbury*[50] and *Stella v. Graham-Paige Motors Corp.*[51] In *Ogsbury* the defendant, director-officer was awarded a non-assignable option to purchase corporate stock. He exercised the option in December 1945 and payment and receipt of stock occurred in December 1948; however, he had sold some shares in July 1948. The court held the purchase date was the date of exercise when the defendant "incurred an irrevocable liability to take and pay for the stock."[52] In *Stella* the defendant, in order to buy ten percent of Kaiser-Frazer stock, executed an executory contract in which the stock purchase was contingent on borrowing the necessary consideration. The court rejected the defendant's contention that the purchase occurred on the contract date and held that the purchase could not occur until the condition precedent had been met.

The court rejected RKO's second argument. It first noted that the merger constituted both the condition precedent to the purchase and the occurrence disposing of Central securities, then applied the pragmatic approach and concluded RKO was a beneficial owner and presumably had had information when it contracted to acquire the Central securities on the condition of a complete merger. The court found ample possibility for insider abuse because RKO could have been gambling on a better exchange ratio, and because RKO could influence the speed and time of the merger, and perhaps its outcome.[53]

RKO made the unique argument that in substance there was no pur-

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[48] Pettys v. Butler, 367 F.2d 528 (8th Cir. 1966), *cert. denied*, 385 U.S. 1006 (1967); Blau v. Lamb, 363 F.2d 507 (2d Cir. 1966), *cert. denied*, 385 U.S. 1002 (1967); Blau v. Max Factor & Co., 342 F.2d 304 (9th Cir.), *cert. denied*, 382 U.S. 892 (1965); Ferraiolo v. Newman, 259 F.2d 342 (6th Cir.), *cert. denied*, 359 U.S. 927 (1958); Roberts v. Eaton, 212 F.2d 82 (2d Cir.), *cert. denied*, 348 U.S. 827 (1954); Blau v. Mission Corp., 212 F.2d 77 (2d Cir. 1954).

[49] 363 F.2d 507 (2d Cir. 1966), *cert. denied*, 385 U.S. 1002 (1967).

[50] 210 F.2d 426 (2d Cir. 1954).

[51] 232 F.2d 299 (2d Cir.), *cert. denied*, 352 U.S. 831 (1956).

[52] 210 F.2d at 427.

[53] In a subsequent opinion the District Court passed on the issue of what amount of profit was realized by RKO, Newmark v. RKO, General, Inc., CCH FED. SEC. REP. PARA. 92,480 (S.D.N.Y. 1969).

chase because their intent was to purchase Central-Frontier stock, not Central stock. The court rejected this theory rather quickly because "the method it used to effectuate its purpose was the acquisition on the common stock and convertible debentures of Central."[54] This segment of the decision could be criticized for the Second Circuit was not consistent in its approach, here using "rule of thumb" type language to find a purchase while using a subjective approach to find a sale.

The inconspicuous effect of section 16(b) is accentuated by the holding in this case. Whether or not the defendant considered possible section 16(b) liability is purely conjectural, but the facts of this case could easily lend themselves to surprise liability under the statute. Before making the investment, RKO should have been warned that a subsequent exchange could be held to constitute a sale for the purpose of section 16(b). The inconsistency is that a statute enacted to create an arbitrary, objective censorship breeds this surprise and confusion. Such situations require the advice and planning of experienced counsel, otherwise they will continue to constitute traps for the unwary.

It would appear that the pragmatic approach of first ascertaining if the transaction lends itself to practices which section 16(b) was intended to prevent assumes a too subject legislative purpose. If the hearings[55] are to be believed, section 16(b) is "designed to remove all temptation to faithlessness,"[56] "to squeeze all possible profits out of stock transactions, and thus to establish a standard so high as to prevent any conflict between the selfish interest of a fiduciary officer, director, or stockholder and the faithful performance of his duty."[57] It is very questionable whether Congress would have provided a "rule of thumb"[58] six-months period or SEC power to exempt[59] if it had intended for the statute to be any less than automatic. As pointed out in *Smolowe*, "had Congress intended that only profits from an actual misuse of inside information should be recoverable, it would have been simple enough to say so. The failure to limit the recovery to profits gained from misuse of information justifies the conclusion that the preamble was inserted for purposes other than as a restriction on the scope of the Act."[60] Note again that a subjective standard of proof would "torture the conditional 'may' in the preamble into a conclusive 'shall have' or 'has.' "[61]

Admittedly, the preamble is a significant part of the statute, and it can be argued that Congress intended it as operative instead of descriptive, but the statute also speaks of recovery, "irrespective of any intention on the part of such beneficial owner, director, or officer in entering into such transaction of holding the security purchased or of not repurchasing the

[54] 294 F. Supp. at 361.
[55] *See* note 5 *supra*.
[56] Cook and Feldman, *Insider Trading Under the Securities Exchange Act*, 66 HARV. L. REV. 385, 407 (1953).
[57] Smolowe v. Delendo Corp., 136 F.2d 231, 239 (2d Cir. 1943).
[58] Note 5 *supra*.
[59] Note 3 *supra*.
[60] 136 F.2d at 236.
[61] *Id.*

security sold for a period exceeding six months."[62] It would appear that if the statute is to remain in force—and if it is not, such is a task for Congress—it should be enforced by the courts in accordance with the intent of the drafters. An objective, arbitrary interpretation would render the insider or potential insider less frequently surprised, better informed of the law, and more knowledgeable as to what his duty is; and it would simplify the already complicated task of our federal courts.

On 17 February 1966, an amendment was adopted to Rule 16(b)-9[63] by the SEC, the effect of which was to put many conversions beyond the reach of section 16(b). The exemption provides in part:

> Any acquisition or disposition of an equity security involved in the conversion of an equity security which, by its terms or pursuant to the terms of the corporate charter or other governing instruments, is convertible immediately or after a stated period of time into another equity security of the same issuer shall be exempt from the operation of Section 16(b) of the Act. . . .[64]

The exemption contains a qualifying proviso to the effect that where the convertible is acquired, the conversion made, and the equity security sold, all within six months, the exemption is denied.

This rule, which is a proper exercise of the SEC's power to exempt, should put to rest much of the litigation under section 16(b) in the convertible security area. It appears that adoption of this rule should be welcomed as a partial solution to an area of the law made confusing by conflicting court decisions. One author, in a recent law review article,[65] ably outlines the arguments favoring an objective approach by the courts and flexibility through SEC rule-making authority. These arguments are, briefly, less uncertainty, uniformity between jurisdictions, ease of amendment and the fairness of establishing guidelines.

III. Corporate Reorganizations

Like situations involving convertible securities, corporate reorganizations have frequently subjected their participants to section 16(b) liability. This subject should be prefaced by a realization that corporate reorganizations take numerous forms and appearances, and the whys and wherefores of these forms are motivated by economic, financial, tax and anti-trust considerations, with a consideration of individual liability for short-swing profits often never being made. However, insiders and/or their counsel should be acutely aware of section 16(b) application to corporate reorganizations.

The first section 16(b) case dealing with corporate reorganizations was *Blau v. Hodgkinson*.[66] Here, the parent corporation adopted a plan of corporate simplification whereby defendants, along with the other sub-

[62] Note 3 *supra*.
[63] 17 C.F.R. § 240, 16b-9 (1966).
[64] *Id.*
[65] Hamilton, *Convertible Securities and Section 16(b): The End of An Era*, 44 Tex. L. Rev. 1447, 1476 (1966).
[66] 100 F. Supp. 361 (S.D.N.Y. 1951).

sidiary stockholders, were given stock of the parent. The defendants were directors of the parent and disposed of the stock within six months. In finding that there was a purchase and that the defendants were liable,[67] the court emphasized that defendants could have exercised their statutory right of dissent to receive the cash value of their shares and did "receive something totally different from that which they surrendered."[68] The latter language could indicate that the court was applying an objective approach. In the similar case of *Stella v. Graham-Paige Motors Corp.*,[69] the Court of Appeals for the Second Circuit likewise found a purchase and imposed liability.

Blau v. Mission Corp.[70] involved two transactions. Defendant Mission Corporation bought Tide Water Associated Oil Company stock in the market, then transferred part to its wholly owned subsidiary, Mission Development Company, in exchange for shares of Development. Subsequently, Mission distributed Development shares to its shareholders in the form of a dividend. After reducing its ownership of Development to about 60 percent, Mission and Development made another exchange of Tide Water stock. In adjudicating that the first Tide Water exchange did not result in a sale by Mission, the court found it "a mere transfer between corporate pockets."[71] But the court held that the second exchange constituted a sale because Development was by then not just the alter ego of Mission and because Mission received "securities which were readily salable and of independent market value."[72] It could well be argued that the court merely presumed no insider abuse in the first transaction, thus frustrating the intent of the statute.

In *Booth v. Varian Associates*,[73] Varian acquired 80 percent of the shares of Bomac Laboratory from defendants who retained the remaining 20 percent and soon became directors of Varian. In 1959 the defendants agreed to sell the 20 percent to Varian with payment in Varian stock and the price of Varian to be established by its market price on the day before closing about 2½ years later. The closing occurred three days early and was followed by a sale of the Varian stock within six months. In adjudicating the defendants liable, the court found the purchase occurred in 1962 because the defendants had no position prior to then.

In *Roberts v. Eaton*[74] the defendants were the Eaton family who owned about 46 percent of the corporation's outstanding $5 par common stock. To facilitate a sale by the family, the corporation underwent a reclassification with the $5 par common being exchanged for $1 par common and $7 par preferred. The defendants disposed of their shares less than one

[67] Under Rule 16b-7, 17 C.F.R. § 240, 16b-7 (1952), when an 85% owned subsidiary receives securities from the parent corporation, it will constitute neither a purchase by subsidiary stockholder nor a sale by the parent.

[68] *Id.* at 373.

[69] Note 48 *supra*.

[70] 212 F.2d 77 (2d Cir.), *cert. denied*, 347 U.S. 1016 (1954).

[71] *Id.* at 80.

[72] *Id.* at 81.

[73] 334 F.2d 1 (1st Cir. 1964), *cert. denied*, 379 U.S. 961 (1965).

[74] 212 F.2d 82 (2d Cir.), *cert. denied*, 348 U.S. 827 (1954).

month after the exchange, the intended disposition having been fully disclosed in the proxy. The Second Circuit absolved the defendants from liability because of the element of disclosure, the time-consuming ratification, their continued interest after the exchange, and the receipt of stock with no pre-existing market value. It must be noted, though, that the purpose of the statute is to limit insider abuse by removing the temptation to realize profits on short-swing trading, and neither the statute nor its legislative history authorizes a court to base a decision on such extra-statutory considerations.

The defendant in *Marquette Cement Mfg. Co. v. Andreas*[75] lost on his defense, although it was based on the subjective holding of *Roberts*. Pursuant to a plan of reorganization, North American Cement Corporation sold its assets to Marquette Cement Manufacturing Company, and the defendant, who was a North American stockholder, received Marquette stock. Because of his extensive knowledge of the cement business, the defendant became a Marquette director. When the defendant sold his stock, the court found that his receipt of Marquette stock as a result of the reorganization constituted a purchase and held him liable under section 16(b). The court attempted to distinguish this case from *Roberts* saying this is "a case where a block of stock is acquired by a separate interest group at a price negotiated by them,"[76] the defendants did not maintain the same interest in the corporation, and "Marquette common had long been traded on the New York Stock Exchange, and the value of the newly issued stock could not have been a matter of complete speculation."[77] In effect, the court, by rejecting the objective test, forced itself to distinguish a recent decision in its own circuit and thus muddied the water for future section 16(b) decisions.

It thus appears that, with the exception of *Roberts* and the first part of *Mission*, the courts have obtained correct results in the reorganization area; however, they have, for the most part, used a not too objective approach, the possible exception being *Hodgkinson*. This raises the question of whether the ingenuity of investors and/or their counsel may someday lead a court applying an approach inconsistent with the intent of the statute, to reach an incorrect result. It appears that the courts have correctly not relied on economic equivalence in this area, and this is supported by the following dictum in *Blau v. Lamb*: "Focus on the factor of economic equivalence is only relevant when—as in a conversion or a reclassification—that which the insider surrenders and that which he receives are simply different forms of the same participation in his issuer."[78]

IV. Conclusion

It would appear that in applying their pragmatic approach of first ascertaining if the transaction lends itself to practices section 16(b) was

[75] 239 F. Supp. 962 (S.D.N.Y. 1965).
[76] *Id.* at 966.
[77] *Id.*
[78] 363 F.2d at 523.

intended to prevent, the courts have read the preamble of section 16(b) as operative instead of descriptive and have rejected other indications that the objective approach was to be the basis of liability. They have disregarded the following characteristics of the statute itself which point toward objectivity: A conditional "may" in the preamble, an objective six month standard, a statement explicitly disregarding intention, and a failure to limit recovery to profits gained from misuse of information. Further, they have disregarded both the intent of the drafters to provide legislation which is designed to deter the temptation to faithlessness, as indicated by the congressional hearings,[79] and the first case[80] to interpret the statute.[81] It is perhaps true that the drafters never contemplated the financial transactions which are everyday affairs for American corporations today; but this statute, which was intended as an established, objective deterrent, breeds surprise and uncertainty when interpreted other than objectively. This is not to say that innocent transactions should be subjected to liability, but if the statute is to be changed, it should be changed by the legislature. The adoption of amended rule 16(b)-9[82] is consistent with the statute and the power of the SEC; thus, it appears as a significant partial solution in the convertible security area.

Regardless of the correct interpretation or application of section 16(b), the insider must live with the positions taken by the courts. The aim of this comment has been to illuminate the hazards and the pitfalls that may confront the corporate insider, especially in dealing with convertible securities and corporate reorganizations. The inconspicuous effect of section 16(b) dictates that every corporate officer, director or ten-percent shareholder and/or his counsel be intricately familiar with the workings of the statute. They must be aware of the special treatment accorded the insider by the statute; and before any purchase, sale, conversion or reorganization, they must consider the probable section 16(b) treatment.

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[79] Note 5 *supra.*

[80] Note 20 *supra.*

[81] The broad reach of the anti-fraud provisions of section 10(b) of the Securities Exchange Act of 1934, 48 Stat. 881 (1934), 15 U.S.C. § 78(j)(b) (1964), as interpreted by the courts, also points toward an objective interpretation of section 16(b).

[82] Note 63 *supra.*