1966

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LIABILITY FOR "SHORT SWING" TRADING IN CORPORATE REORGANIZATIONS

by

Robert Todd Lang* and Melvin Katz**

SECTION 16(b) of the Securities Exchange Act of 1934¹ was enacted as a remedial measure to force corporate insiders to disgorge profits realized from "short swing" trading in the equity securities of listed companies. In 1964, Congress extended the coverage of section 16(b) to the insiders of larger over-the-counter companies.² As a result, section 16(b) now affects a far greater number of officers, directors and principal shareholders³ of companies whose trading activities were, prior to such amendments, beyond its reach.

Section 16(b) is now applicable to officers, directors and holders of more than ten per cent of each class of the outstanding equity securities of any issuer which has one or more outstanding classes of securities either listed on a national securities exchange or registered under section 12(g) of the Exchange Act.⁴ Briefly, it provides that

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¹ 15 U.S.C. § 78a-jj. The statute is hereinafter referred to as the "Exchange Act."
² See § 12(g)(1) of the Exchange Act [15 U.S.C. § 78 l(g)(1)] pursuant to which companies whose outstanding equity securities are traded solely in the over-the-counter market, but which have more than 500 shareholders of record at the close of their first fiscal year ending after July 1, 1966, are now required to register such class of securities with the SEC. By virtue of the amendments to the Exchange Act in 1964, issuers in this category are now subject to the reporting requirements under § 13, the proxy regulations under § 14, and their officers, directors and the holders of more than 10% of each class of their outstanding equity securities are subject to the provisions of § 16.
³ Officers, directors and holders of more than 10% of any outstanding class of equity securities of any issuer subject to the provisions of § 16 of the Exchange Act are referred to throughout this Article as "insiders."
⁴ The language of § 16(b) is as follows:
   (b) 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
any profits realized within a six-month period by any such "insider" from each combination of purchase and subsequent sale, or sale and subsequent purchase, of the equity securities of such issuer must be repaid in full to the issuer. This enforces the statutory goal of precluding the use of inside information in making "short swing" profits.

As a parallel to section 16(b), Congress also enacted section 16(a) which requires that insiders report their ownership of, and transactions in, securities of the issuer.\(^5\)

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Reports under § 16(a) are filed on form 3 (the "initial" report) and form 4 (report reflecting subsequent changes in the amount of securities held by the insider). See Cook & Feldman, Insider Trading Under the Securities Exchange Act, 66 HARV. L. REV. 385 (1952) for a discussion of the reporting requirements under § 16(a). See also SEC Securities Exchange Act Release Nos. 7794, 7795 concerning proposed amendments to the reporting rules under § 16(a) with respect to the acquisition of "puts" and "calls" and proposed revisions to forms 3 and 4 resulting therefrom.

While this Article is not concerned with technical questions under § 16(a), it should be noted that, pursuant to SEC Securities Exchange Act Release No. 7824 (originally published as SEC Securities Exchange Act Release No. 7793), the SEC set forth its position respecting the definition of "beneficial ownership of securities" within the meaning of § 16(a).

In part, this constituted a restatement, albeit considerably expanded, of the SEC's earlier interpretation of beneficial ownership of securities under the statute. See SEC Securities Exchange Act Release No. 175 (1935). Briefly, Release No. 7824 states that securities which are held of record by a spouse or minor child of the reporting insider, shall, in the absence of special circumstances, be regarded as owned beneficially by the reporting person. The release also indicates that where securities are held of record by any person pursuant to an arrangement or contract whereby the reporting insider obtains benefits substantially equivalent to ownership, such securities are to be regarded as beneficially owned by such reporting insider. The SEC's stated rationale for these expanded criteria in defining beneficial ownership is based upon what may be called a "powers" test and a "benefits" test. These two tests are directed toward ascertaining the substantive issue of economic benefits normally derived from, or power to control the disposition or voting of securities normally associated with, ownership of securities regardless of the form in which they are held. But the significance of this expanded definition of beneficial ownership relates not merely to insiders' reporting requirements under § 16(a). The implications of this release reach into the question of possible civil liability resulting from short swing trading under § 16(b). The Commission itself has hinted in Release No. 7824 that reporting ownership of shares held, for instance, by a member of one's immediate family, does " . . . not necessarily mean that liability will result therefrom under Section 16(b)." However, it is fair to assume that trading by such persons exposes the insider to the serious possibility of liability under § 16(b). In this respect, the meaning of the Commission's release is vague. However, see Marquette Cement Mfg. Co. v. Andreas, 239 F. Supp. 962, 967 (S.D.N.Y. 1965) where the court, referring to rule 16a-8 (17 C.F.R. § 240.16a-8) dealing with reporting of ownership of shares held in trust, stated that the rules respecting reporting of ownership of shares under § 16(a) have little significance for determining liability under § 16(b).

In addition, § 16 also contains the following provisions:

(1) Section 16(c), which makes it unlawful for insiders to engage in "short sales" of equity securities of the issuer, or to sell such securities and not make prompt delivery thereof—a practice commonly known as selling "against the box." See Silverman v. Landa, 200 F. Supp. 193 (S.D.N.Y. 1962), aff'd, 106 F.2d 422 (2d Cir. 1962) for a discussion of the provisions of § 16(c).

(2) Section 16(d), added by amendment in 1964, which exempts from the provisions of §§ 16(b) and (c) over-the-counter securities transactions by insiders of companies whose equity securities are registered under § 12(g) of the Exchange Act where such insider is a
In addition to the power granted to the Securities and Exchange Commission (the SEC) to exempt certain securities transactions not comprehended within the purposes of the statute, section 16(b) expressly excepts profits derived by insiders from trading in securities which were acquired in good faith "in connection with a debt previously contracted." This exception has been construed by the courts to refer only to a security acquired by the insider in satisfaction of a matured debt arising independent of any obligation to transfer such security. The statute further provides that it shall not be construed to cover any transaction where "the beneficial holder of more than 10 per cent of the outstanding class was not such both at the time of the purchase and sale, or the sale and purchase, of the security involved." This exception has been construed by the courts so as to be inapplicable to that purchase whereby such insider became the holder of more than ten per cent of an outstanding class of equity securities of the issuer.

The contours of the statute as interpreted by the courts are relatively clear with respect to ordinary cash purchases and sales of securities by an insider within any six-month period. There are, of course, numerous interpretative questions arising out of such ordinary securities transactions, including the computation of dividends in determin-
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ing realized profits,8 measurement of the six-month period,9 status as a director at the time of purchase and sale of the securities,10 tolling of the applicable two-year statute of limitations,11 categories of employees who may be deemed officers,12 settlement of actions under section 16(b),13 and interpretation of its two express exceptions referred to above. However, these questions, which are the subject of precedent or have been well analyzed elsewhere,14 are not the primary concern of this Article. Rather, this Article is directed toward an analysis of problems arising from the application of section 16(b) to non-cash transactions, including corporate reorganizations, acquisitions and reclassifications. The form of these transactions is frequently determined by tax, commercial, anti-trust or other considerations, and ideally the perimeters of section 16(b) should be carefully delineated so as to accomplish only the statutory objective of curbing speculative abuse by insiders in the context of corporate transactions which often serve salutary purposes for the corporations involved and their shareholders. Despite these considerations, the application of section 16(b) to these transactions has sometimes led to harsh, uncertain and unanticipated results.

**DEFINITION OF "PURCHASE AND SALE" UNDER SECTION 16(b)**

Liability under section 16(b) often turns upon a determination of when a “purchase” or a “sale” of securities has occurred for section 16(b) purposes. Section 3(a)(13) of the Exchange Act defines

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8 Western Auto Supply Co. v. Gamble Skogmo, Inc., 348 F.2d 736 (8th Cir. 1965), cert. denied, 382 U.S. 987 (1966). But see note 75 infra.
“purchase” to include “any contract to buy, purchase or otherwise acquire,” and section 3(a)(14) defines “sale” to include “any contract to sell or otherwise dispose of.” These statutory definitions do not furnish explicit direction with respect to the treatment under section 16(b) of insiders’ securities transactions in corporate reorganizations, acquisitions, reclassifications and conversions. Therefore, in applying the concept of “purchase” and “sale” to securities transactions in this area, it is necessary to examine the purposes underlying the enactment by Congress of section 16(b).

The preamble to section 16(b) states that it was enacted, “For the purpose of preventing the unfair use of inside information which may have been obtained by [insiders]. . . .” This would seem to require that the courts determine whether the particular securities transactions under scrutiny are susceptible to the possibility of abuse of inside information. On the other hand, section 16(b) sets forth a seemingly automatic rule which imposes liability upon insiders for any trading resulting in a profit within any period of six months or less, regardless of the intentions or purposes of the insiders engaged in such trading or other similar extrinsic considerations. Those provisions would appear to preclude inquiry by the courts beyond the question of whether the insider’s purchase and sale of the securities were both made within the statutory period. Thus, there are conflicting approaches to the imposition of liability under the statute which have led to confusion and uncertainty. This conflict has been demonstrated most often in cases dealing with conversions of securities. Accordingly, a review of these cases furnishes a useful background to the interpretation of section 16(b) with respect to insider’s securities transactions in corporate reorganizations, acquisitions and reclassifications.

THE “CONVERSION” CASES

In Park & Tilford v. Schulte, the first reported decision in this area, the Second Circuit, adopting an objective, “rule of thumb” approach, held that the defendant’s conversion of preferred stock into common stock constituted a “purchase” of such common stock for section 16(b) purposes which rendered the insiders liable for profits derived from a sale of the common stock within six months after the date of such conversion. In reaching this decision, the Sec-
Second Circuit stated in substance that any conversion of one class of securities into another class of securities of the same issuer constituted a “purchase” within the meaning of section 3(a)(13) of the Exchange Act as a “contract . . . to acquire.” This reflected the court’s adoption of what has since been viewed as an “automatic” interpretation of the statute with respect to any combination of acquisitions and dispositions of securities within any six-month period. However, in 1958, in Ferraiolo v. Newman, the Sixth Circuit reached a result contrary to the Park & Tilford approach by holding that the conversion of preferred stock into common stock in that case was not a “purchase” which could be matched with a subsequent sale of the underlying common stock to impose liability under section 16(b). In Ferraiolo, the court found that there was no evidence that the insider controlled the issuer’s decision to call the preferred stock for redemption which resulted in a “forced” conversion; it further found that the convertible preferred and common stock were “economic equivalent[s]” in terms of values ascribed to both classes of such securities in the market. This decision placed heavy emphasis upon the stated purpose of the statute to prevent the use of inside information for speculative purposes rather than upon a “rule of thumb” approach which would preclude inquiry into such extrinsic factors as the insider’s lack of actual control of the issuer. The very fact that the Sixth Circuit sought to distinguish the decision of the Second Circuit in the Park & Tilford case on these grounds reflected its refusal to be bound solely by the ostensibly objective language of section 16(b). The different approaches of the Second and Sixth Circuits to conversions under section 16(b) were reflected in decisions subsequently rendered by the Ninth Circuit and by a district court in Minnesota.

18 Id. at 987.
21 Id. at 345-46.
22 Ibid.
23 Until recently the conflicting positions taken by the different courts evidenced the confusion resulting from the two different interpretative approaches to § 16(b). Thus, in Blau v. Max Factor & Co., 342 F.2d 104 (9th Cir. 1965), cert. denied, 382 U.S. 892 (1961), the Ninth Circuit held that the conversion by insiders of one class of common stock into another class of common stock, both of which classes being in all respects alike except with respect to dividend rights, did not constitute a “purchase.” On its facts, this case went even further than the Ferraiolo case since the insiders were clearly controlling persons (as they were in the Park & Tilford case) and since the conversion was clearly preparatory to a public offering. This case led to the adoption by the SEC of rule 16b-9, [17 C.F.R. § 240.16b-9, SEC Securities Exchange Act Release No. 7118 (1961)] which retroactively exempted an exchange of shares of one class of securities for another which have the same rights and privileges except for dividend rights. Rule 16b-9 was sub-
Two recent court decisions have highlighted the dilemma of the courts in applying section 16(b) to conversions. These two cases, *Heli-Coil v. Webster* and *Blau v. Lamb*, are also significant because of the light they shed on the analogous problem of applying section 16(b) to insiders’ transactions incident to a corporate reorganization.

In the *Heli-Coil* case a director converted convertible debentures into common stock within six months after the date of their purchase and sold the common stock within six months after the date of such conversion (but more than six months after the date of purchase of the debentures). The questions presented to the Third Circuit were: (1) whether the conversion of the convertible debentures into common stock constituted a “purchase” of the common stock within the meaning of section 16(b), and (2) whether that same act of conversion of the debentures into the common stock constituted a “sale” of such debentures which could be matched with their prior purchase. Thus, the court was obliged to consider two separate counts of potential section 16(b) liability arising out of a single act of conversion of a security which could be matched with a prior purchase of the convertible security and a subsequent sale of the underlying security.

Subsequently amended in 1966 by SEC Securities Exchange Act Release No. 7826, CCH Fed. Sec. L. Rep. ¶ 77329. See note 34 infra and accompanying text for a description of the provisions and significance of rule 16b-9. On the other hand, in *Pettys v. Northwest Airlines*, 246 F. Supp. 526 (D. Minn. 1965), a district court followed the *Park & Tilford* approach even though the facts more closely resembled the facts in the *Ferraiolo* case. In the *Pettys* case, two non-controlling directors of the issuer who held convertible preferred for more than six months, converted such preferred stock to avoid redemption and then sold the common stock within six months after the conversion. The court specifically rejected the *Ferraiolo* and *Max Factor* holdings and held that the conversion constituted a “purchase” of securities within the meaning of § 16(b). The district court's holding was reversed by a decision rendered by the Eighth Circuit in October 1966 (CCH Fed. Sec. L. Rep. ¶ 90,828) wherein the court held that a conversion of preferred stock into common stock did not constitute a “purchase” within the meaning of section 16(b). In reaching this result the Eighth Circuit, after reviewing the precedents, including *Blau v. Max Factor*, held that where the marketable convertible preferred stock and the underlying common stock were economic equivalents in the market place, the act of conversion did not alter the insider's investment risk and hence did not involve a transaction which would be susceptible to the possibility of speculative abuse. In reaching this decision, the Eighth Circuit employed reasoning which parallels that of the Second Circuit in *Blau v. Lamb*. See discussion in text accompanying notes 29-33 infra.

*Author's Note:* In October 1966 the Eighth Circuit reversed the district court in Minnesota in the case of *Pettys v. Northwest Airlines*, by holding that a conversion of preferred stock into common stock did not constitute a “purchase” within the meaning of section 16(b). This very recent decision of the Eighth Circuit in the *Pettys* case reflects the same philosophy as that taken by the Second Circuit in *Blau v. Lamb* except that the language in the *Pettys* case might well indicate that the Eighth Circuit would adopt a more flexible approach than the Second Circuit in deciding upon cases involving conversions or corporate reorganizations under section 16(b). It would appear that at present the judicial approach to section 16(b) embodied in the *Ferraiolo* case may well represent the dominant approach of the various circuits in this area.

*352 F.2d 156 (3d Cir. 1965).*

*352 F.2d 156 (3d Cir. 1965); CCH Fed. Sec. L. Rep. ¶ 91,710.*
The court, following *Park & Tilford*, held that the conversion of the debentures constituted a “purchase” of the common stock which could be combined with a subsequent sale of such stock to impose liability under section 16(b). However, while it also held that the conversion constituted a “sale” of the debentures which could be matched up with their prior purchase, the court imposed no section 16(b) liability since such “sale” did not result in the “realization of profit.” Its basis for this conclusion was that the convertible debentures and the underlying common stock were “substantial economic equivalent[s]” and that the paper value of the debentures held by the insider did not materialize into “real” value by reason of the conversion. The decision in *Heli-Coil*, which was urged upon it by the amicus brief of the SEC, represents a compromise between a strict adherence to the *Park & Tilford* approach and an effort to avoid the harsh consequences upon the insider resulting from that approach. This is evidenced by the fact that, despite its refusal to impose liability upon the insider by reason of that aspect of the conversion which it held to constitute a “sale,” the court nevertheless found such liability by matching the conversion of the debentures as a “purchase” with the subsequent sale of the underlying common stock even though such underlying stock was sold more than six months after the date of the purchase by the insider of the convertible debentures.

In June, 1966, the Second Circuit decided *Blau v. Lamb*, which involved, among other securities transactions, the acquisition of convertible preferred stock of a company by a principal shareholder incident to a merger and a later conversion of such preferred stock into common stock of the same company within six months of the acquisition. The district court had held that the acquisition of the convertible preferred stock pursuant to the merger constituted a “purchase” within the meaning of section 16(b), and this was not contested on appeal. The Second Circuit held that the conversion of the preferred stock into shares of common stock within six months after the date of the admitted “purchase” of the preferred did not constitute a “sale” within the meaning of section 16(b). In reaching this result, the court rejected an automatic construction of section 16(b), preferring

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20 For a comprehensive discussion by Judge Biggs of the conflicting philosophies theretofore adopted by the courts with respect to imposing § 16(b) liability in the area of conversion of securities, see *Heli-Coil Corp. v. Webster*, 352 F.2d 156, 161-67 (3d Cir. 1965).

21 *Id.* at 167.

22 *Id.* at 169-70.

23 CCH Fed. Sec. L. REP. ¶ 91,710. According to CCH Fed. Sec. L. REP. Bulletin 120 (Nov. 3, 1966), a petition for *certiorari* has been filed in *Blau v. Lamb*.

24 *Id.* at ¶ 95,611.
instead to determine whether the transaction in question could possibly lend itself to speculative abuse. Thus, Judge Waterman stated:

To be sure, the theory of regulation underlying Section 16(b)'s regulatory mechanism provides a sufficient reason for refusing to examine the details of transactions once it has been determined that they might possibly have served as vehicles for unfair insider trading. But it does not supply an equally sufficient reason for applying Section 16(b) in this same automatic fashion when a substantial question is raised whether a certain conversion transaction permits a possibility of insider abuse. Congress adopted the sweeping, arbitrary regulatory mechanism embodied in Section 16(b) in order to insure that even the possibility of insider abuse was deterred, but it would seem to follow that in order to avoid 'purposeless harshness' a court should first inquire whether a given transaction could possibly tend to accomplish the practices Section 16(b) was designed to prevent. Blau v. Max Factor & Co., supra at 307. [Emphasis added.]

Having adopted this flexible approach, the court found that there could be no such speculative abuse because the convertible preferred stock and the common stock were "economic equivalents" in terms of market values and that, in consequence, the conversion did not constitute a change in the investment position of the insiders. However, it carefully limited the concept of economic equivalence to those situations where the convertible security had an ascertainable market value and where such market value was at least equal to the market value of the underlying security. Thus, where the Third Circuit in Heli-Coil relied upon the test of "economic equivalence" to determine that no profit had been "realized" within the meaning of the statute so as to avoid imposition of a harsh and inequitable liability, the Second Circuit in Blau v. Lamb employed the concept of "economic equivalence" as the basis for its finding that the possibility of speculative abuse was non-existent.

One of the most significant aspects of the decision in Blau v. Lamb is that the same circuit which was responsible for the automatic approach to section 16(b) exemplified by the Park & Tilford case has now rejected an automatic approach to the interpretation of section 16(b) in the area of convertible securities. That Judge Waterman expressly limited the court's holding to the facts of the case and declined to rule, for instance, on acts of conversion followed or preceded by purchases or sales of the underlying security does not inval-

31 Id. at § 95,613.
32 Id. at §§ 95,615-16. The court was most careful to restrict its holding to the facts present. However, it set forth four prototype situations, the first of which involved its holding that a purchase of convertible preferred stock followed by a conversion of such stock into common stock within six months thereafter did not constitute a "sale" of the con-
idate the conclusion that the Second Circuit has now adopted a philos-

ophy in applying section 16(b) which parallels that of the Sixth Circuit in *Ferraiolo.*

In February, 1966, the SEC amended rule 16b-9 to provide that

vertible security. It expressly declined to rule, however, on the three following prototype situations:

(i) The conversion by an insider of preferred stock held for more than six months which is followed by another purchase of such convertible preferred stock at a lower price within six months after the date of conversion.

(ii) A sale of the underlying common stock within six months prior to the date of conversion of the convertible preferred stock, where such sale is at a higher price than the conversion price; and

(iii) Where the sale of the underlying common stock occurs within six months after the date of conversion of the preferred stock.

With respect to these prototypes, Judge Waterman, in limiting the court's holding, again restated the view that, prior to imposing liability under § 16(b), a judge should first ascertain whether any possibility of speculative abuse was presented under the facts of each such prototype. Significantly, Judge Waterman, bowing perhaps to the force of *Park & Tilford* as precedent, indicated that this type of analysis might lead to the conclusion that a conversion when followed by a sale of the underlying security within six months thereafter might constitute a "purchase" of such underlying security even though the same act of conversion might not constitute a "sale" of the convertible security purchased within six months prior thereto. CCH FED. SEC. L. REP. § 91,710 at 95,617. These limitations upon its holding indicate that the Second Circuit's decision in Blau v. Lamb is considerably narrower than the scope of the exemption provided by the recent amendment to rule 16b-9 discussed in the text accompanying notes 34-37 infra.

* Author's Note: In October 1966 the Eighth Circuit reversed the district court in Minnesota in the case of Pettys v. Northwest Airlines, by holding that a conversion of preferred stock into common stock did not constitute a "purchase" within the meaning of section 16(b). This very recent decision of the Eighth Circuit in the *Pettys* case reflects the same philosophy as that taken by the Second Circuit in Blau v. Lamb except that the language in the *Pettys* case might well indicate that the Eighth Circuit would adopt a more flexible approach than the Second Circuit in deciding upon cases involving conversions or corporate reorganizations under section 16(b). It would appear that at present the judicial approach to section 16(b) embodied in the *Ferraiolo* case may well represent the dominant approach of the various circuits in this area.


(a) 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; Provided, however, that this rule shall not apply to the extent that there shall have been either (i) a purchase of any equity security of the class convertible (including any acquisition of or change in a conversion privilege) and a sale of any equity security of the class issuable upon conversion, or (ii) a sale of any equity security of the class convertible and any purchase of any equity security issuable upon conversion, (otherwise than in a transaction involved in such conversion or in a transaction exempted by any other rule than under Section 16(b)), within a period of less than six months which includes the date of conversion.

(b) For the purpose of this rule, an equity security shall not be deemed to be acquired or disposed of upon conversion of any equity security if the terms of the equity security converted require the payment or entail the receipt, in connection with such conversion, of cash or other property (other than equity securities involved in the conversion) equal in value at the time of conversion to more than 15% of the value of the equity security issued upon conversion.

(c) For the purpose of this rule, an equity security shall be deemed con-
the acquisition or disposition of an equity security upon conversion of one class of such security into another class of equity security of the same issuer shall be exempt from the operation of section 16(b). This exemption is subject, however, to the proviso that it is not deemed applicable to the extent that there has been a combination of either a "purchase" of the convertible security and a "sale" of the underlying security, or a "sale" of the convertible security and a "purchase" of the underlying security, within any period of less than six months, which includes the date of the conversion.\textsuperscript{5} The rule also qualifies the exemption by providing that an equity security shall not be deemed to have been acquired or disposed of upon conversion if, in connection with such conversion, the insider either receives or is required to pay cash or other property equal to more than fifteen per cent of the value of the underlying securities issued upon such conversion.\textsuperscript{6} As amended, rule 16b-9 renders academic the existing court decisions with respect to the application of section 16(b) to conversions. Moreover, rule 16b-9 now exempts securities transactions involving conversions which the court in \textit{Blau v. Lamb} was careful to exclude from its narrow holding that a conversion of preferred stock within six months after the date of purchase did not constitute a "sale" of the preferred stock for section 16(b) purposes. Thus, where the Second Circuit, by way of illustration, specifically left open the question of liability under section 16(b) for conversions preceded or followed by a sale or purchase of the underlying security within a period of six months from the date of such conversion,\textsuperscript{7} such combination of transactions would clearly be exempt under rule 16b-9 unless the purchase of the convertible security, the conversion, and the sale of the underlying security all occurred within a six-month period. This amendment to rule 16b-9 demonstrates the willingness of the SEC to use its broad statutory power to promulgate a general rule which resolves problems created by conflicting interpretations of section 16(b).

\textbf{Corporate Reorganizations and Section 16(b)}

The conversion cases are only partly applicable to corporate reorganizations and acquisitions which involve transactions in the securities of more than one issuer. For purposes of section 16(b), such

\textsuperscript{5} 17 C.F.R. § 240.16b-9(a).
\textsuperscript{6} 17 C.F.R. § 240.16b-9(b).
\textsuperscript{7} See note 33 supra.
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reorganizations and acquisitions involve potential liabilities to the insider which may arise from the transfer or exchange of the securities of one corporation for those of a second or third corporation.

In dealing with insider's securities transactions arising out of corporate mergers and other types of reorganizations, the courts have, subject to certain exceptions noted below, adopted the automatic, objective approach exemplified by the Park & Tilford decision. The first case to deal with a corporate reorganization was Blau v. Hodgkinson which involved the merger and liquidation of several subsidiaries into their corporate parent. A director of the corporate parent, who held securities of one of such subsidiaries prior to the merger and received shares of the parent upon liquidation of the subsidiary, was held accountable under section 16(b) by reason of profits derived from a sale of the parent's shares within six months after the date of such liquidation. The district court in the Hodgkinson case held that an exchange of shares pursuant to the statutory merger of a subsidiary into a parent corporation constituted a "purchase" by the insider of the shares of the parent. The court stressed the element of choice which was available to the shareholder of the subsidiary and, in effect, stated that the acquisition by him of the parent's share was "voluntary" because the defendant could have dissented from the merger and exercised his statutory appraisal rights under state law. Similarly, in Stella v. Graham-Paige Motors Corp., the Second Circuit held that the exchange of assets by Graham-Paige for stock of Kaiser-Fraser constituted a "purchase" of the latter's securities for section 16(b) purposes which could be matched with the sale of such stock within six months thereafter to invoke liability. More recently, a district court arrived at a similar result in the case of Marquette Cement Mfg. Co. v. Andreas where it held that an exchange of assets by one corporation for shares of another corporation followed by liquidation of the former constituted a "purchase" of such shares by the shareholders of such former corporation upon its liquidation. The court matched this "purchase" of such shares with their subsequent sale to find liability under section 16(b). In addition, in Fistel v. Christman, a case involving a transfer of the

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83 Id. at 373.
84 232 F.2d 299 (2d Cir. 1956).
86 Ibid. The insiders in the Marquette Cement case included a corporation and a trust of which one of the insiders was a beneficiary. See note 5 supra, respecting the view of the court in this case that the reporting rules under § 16(a) have only slight significance in determining liability under § 16(b).
outstanding shares by shareholders of one corporation in exchange for shares of another corporation, a district court, although finding that there was no recoverable profit under the facts of that case, nevertheless held that such transfer constituted a “purchase” for section 16(b) purposes. Most recently, the district court in *Blau v. Lamb* held, after citing the *Hodgkinson* and *Graham-Paige* cases, that the exchange by an insider of common shares of one corporation for preferred shares of another corporation pursuant to a merger constituted a “purchase” of such preferred shares within the meaning of section 16(b), and this holding was not contested on appeal to the Second Circuit. Significantly, the court in *Blau v. Lamb* stated that the test of “economic equivalence” with respect to conversion of one class of securities into another class of the same issuer would have no applicability where the insider exchanged securities of the issuer for securities of a different issuer. In this respect *Blau v. Lamb* is also consistent with the *Hodgkinson, Graham-Paige, and Marquette Cement* cases where the holdings implicitly, but properly, reject the application of the concept of “economic equivalence” to a transfer of securities or assets of one issuer in exchange for securities of another issuer.

On the other hand, the Second Circuit in *Blau v. Mission Corp.* held that the transfer by an insider corporate parent to its wholly-owned subsidiary of shares of a third corporation in exchange for shares of such subsidiary did not constitute a “sale” by such parent within the meaning of section 16(b), and there is dictum in the *Marquette Cement* case to the effect that a transaction would not be deemed within the purview of section 16(b) where “elements which convince the court that manipulation is impossible” are present.

In 1954, in *Roberts v. Eaton,* which involved a reclassification of the shares of an issuer after approval by shareholders pursuant to applicable statutory procedure, the Second Circuit held that such reclassification did not constitute a “purchase” within the meaning of section 16(b) which would be matched up with a private sale of such shares one month thereafter. Emphasizing the like treatment of all

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45 CCH Fed. Sec. L. Rep. ¶ 91,710 at 95,611.
46 Id. at 95,616.
47 212 F.2d 77 (2d Cir. 1954).
48 In *Blau v. Lamb,* *supra,* the court extended the holding of *Blau v. Mission Corp.* to apply to a 97%! owned subsidiary of the insider, indicating that, even though it could not fix a precise limit with respect to this question, the transfer of securities to a 97%! owned subsidiary in no way increased the insider’s power to make use of the inside information which § 16(b) is designed to preclude. CCH Fed. Sec. L. Rep. ¶ 91,710 at 95,619.
49 239 F. Supp. at 966.
50 212 F.2d 82 (2d Cir. 1954).
shareholders and the retention by the insiders of the same proportionate equity interests in the issuer, the court specifically found that the reclassification could not possibly lend itself to the speculative abuse which section 16(b) was designed to prevent, thereby adopting an approach in the area of reclassification which was consistent with that in Ferraiolo and Blau v. Lamb with regard to conversions of securities of the same issuer.

Except for Blau v. Mission Corp. and Roberts v. Eaton, the courts have reached decisions respecting section 16(b) which may be justifiably regarded as imposing unintended hardships on corporate insiders. The decision in Blau v. Lamb, however, indicates that now the courts may, by relating the imposition of liability under the statute only to such transactions as involve the possibility of abuse of inside information, be attempting to avoid such harsh results. The question remains whether this interpretative approach will be applied to the area of corporate reorganizations and like transactions. The companion question is whether the courts, required to deal with complicated corporate transactions on a case by case basis, can enunciate a general rule which will both restrict section 16(b) liability to those transactions as fall within its purpose and serve as a clear guide to corporate insiders and their counsel. Therefore, to achieve both the discriminating and equitable purposes which the Blau v. Lamb approach to section 16(b) is intended to serve and at the same time avoid the uncertainties which that approach is likely to yield, it would be preferable if the interpretative problems presented in this area were resolved by a specific SEC rule exempting acquisitions or dispositions of securities incident to a corporate reorganization as transactions "not comprehended within the purpose of" section 16(b).

Corporate reorganizations and acquisitions are accomplished

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51 Id. at 83-85.
52 Existing rule 16b-7, promulgated by the SEC in 1952 (17 C.F.R. § 240.16b-7), adopted by SEC Securities Exchange Act Release No. 4717 (1952) only has applicability to acquisitions or dispositions of securities pursuant to mergers, consolidations (including, by definition in rule 16b-7(b), exchanges of assets for securities) involving 85% or more owned subsidiaries (or companies owning 85% or more of the combined book values of the companies which are parties to the transaction) and therefore it is not applicable to the situation where two or more previously unaffiliated corporations become parties to a corporate reorganization. The discussion in this Article is devoted to an analysis of problems posed by § 16(b) in the context of corporate reorganizations involving previously unaffiliated corporations. See note 70 infra, respecting the limitations upon the scope of the exemption provided by this rule which are set forth in rule 16b-7(c).

In addition, rule 16b-6(c) (17 C.F.R. § 240.16b-6(c)) also provides a limited exemption with respect to the disposition of a security pursuant to a merger, consolidation, reclassification of securities, or exchange of assets for securities where such security was acquired upon exercise of an option or pursuant to an employment agreement which was granted or entered into more than six months prior to such exercise. The rule specifically requires that such merger, consolidation, reclassification or exchange of assets for securities be binding upon shareholders except for the exercise of statutory appraisal rights which may be available.
through various methods which are undertaken to satisfy specific financial, corporate or tax objectives. Principally, such transactions involve either mergers, consolidations, exchanges of securities by the shareholders of Corporation A (A) for securities of Corporation B (B), or exchanges of assets of A for securities of B followed by a liquidation of A and the distribution of B’s securities to the shareholders of A. The form of the transaction should be of little consequence in determining whether the insider’s trade lends itself to speculative abuse. Regardless of which method of corporate reorganization or acquisition is employed, however, it may be assumed that there is no section 16(b) liability resulting solely from a matching of the acquisition (a “purchase”) by the insider of equity securities of B in exchange for the disposition (a “sale”) of equity securities of A. By its terms, section 16(b) reaches only the combination of a purchase and sale of equity securities of one issuer resulting in a profit, and, accordingly, the event of the reorganization, itself, does not give rise to liability thereunder. However, serious interpretative problems under section 16(b) arise out of the matching of the “purchase” or “sale” of equity securities incident to the merger or other form of corporate reorganization with any prior or subsequent acquisition or disposition of such securities by an insider subject to the provisions of section 16(b). The main problem in this area may be illustrated by the two following prototype fact situations which appear applicable regardless of the form of reorganization employed.\(^2\)

The first of these prototype situations is where the insider has made a purchase of equity securities of A within six months prior to the date of the merger of A into B or the acquisition of A by B—in effect, where such prior purchase of securities of A may be matched up with the subsequent transfer or exchange of such securities pursuant to the reorganization (a “sale” for section 16(b) purposes) to invoke liability under the statute. While it is evident that an insider of A might possibly have used inside information in connection with the purchase of the equity securities of A within six months of the reorganization, it is doubtful if such “purchase” should be matched with the “sale” of such securities arising by reason of such reorganization. To the extent that the insider of A receives equity securities of B upon the reorganization, such insider does not realize a profit by reason of the reorganization. Realization in an economic sense only occurs when the insider of A sells the securities of B or receives cash or

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\(^2\) These prototype illustrations are based upon the factual assumption that the insider of A does not become an insider of B until such time as the reorganization is consummated. Clearly, different results could obtain if the insider of A is also an insider of B prior to the reorganization. See paragraph (ii) of note 54 infra.
non-equity securities of B pursuant to the reorganization. It does not occur where the insider is receiving only equity securities of B in exchange and substitution for his equity securities of A pursuant to the reorganization and where he occupies the same position as all other holders of equity securities of the same class of A. Thus, the absence of realization is further demonstrated by the fact that the transfer of securities of A incident to the reorganization does not alter the insider’s proportionate equity interest in relation to the interests of all other holders of the same class of equity securities of A. Therefore, the event of the reorganization should not be deemed the determining factor in terms of the prevention of speculative abuse under section 16(b).

The second prototype situation involves the acquisition by the insider of A of equity securities of B incident to a merger or other form of corporate reorganization (i.e., a “purchase” for section 16(b) purposes) and the subsequent sale of such securities by such insider within six months thereafter. It is particularly in this area where, as illustrated by the decisions in the Hodgkinson and Marquette Cement cases, the imposition of liability under section 16(b) has worked unintended hardships upon the corporate insider. This is true because the reorganization, whereby the insider has “purchased” the securities...

54 The first prototype illustration set forth in the text is subject to several possible variations. Such variations include:

(i) Where the insider of A has made a sale of securities of B within six months prior to the date of the reorganization (and prior to the date upon which he has become an insider of B), and where such prior sale of securities of B can be matched with the subsequent acquisition of B’s securities pursuant to the corporate reorganization. It would appear that the possibilities for abuse of inside information by the insider in this factual situation are the same as in the first prototype illustration in the text. Moreover, under existing law, the fact that such person was not an insider of B both at the time of prior sale and subsequent purchase would not relieve him of §16(b) liability in the light of the decisions in Blau v. Allen and Adler v. Klawans, cited in note 10 supra.

(ii) Where an insider of B purchases securities of A within six months prior to the reorganization and then disposes of such securities in exchange for additional securities of B upon the reorganization, you cannot match, insofar as the securities of B are concerned, two purchases of B’s securities for purposes of §16(b). Nor could such liability be imposed under the facts of this illustration with respect to trading in the securities of A since such person was never an insider of A. In this type of transaction, however, it would appear that if the purchase of A’s securities prior to the reorganization was based upon an abuse of confidential information, a civil action would lie under rule 10b-5. Compare the allegations of the SEC in SEC v. Golconda Mining Co., et al. SEC Litigation Release No. 3235 (1965) which involved a sale of securities of A and a purchase of securities of B prior to the announcement of a proposed merger. One of the defendants in this case was an insider of both A and B and the SEC is seeking an injunction against further violations of rule 10b-5 plus restitution to each person from whom the defendants purchased securities of B and to whom they sold securities of A prior to the date of public announcement of the merger.

Compare discussion concerning lack of realization of profit within the meanings of §16(b) in Heli-Coil v. Webster, cited in notes 27 and 28, supra. Significantly, the conclusion that there was no such realization in the Heli-Coil case was urged upon the Third Circuit by the amicus brief of the SEC.
ties of B, has presumably been consummated only after shareholders of A have had an opportunity to pass upon and approve the acquisition and, therefore, the possibilities of the abuse of inside information in connection with such "purchase" of the securities of B, and their subsequent sale do not seem materially significant. In fact, from the standpoint of possible speculative abuses, it can be argued that this prototype presents the strongest factual case against applying section 16(b) liability to a combination of two securities transactions, one of which involves the transfer or exchange of securities incident to a corporate reorganization. The insider in this illustration may well have availed himself of inside information to sell securities within six months after such reorganization; but, as noted in the first prototype, the insider has acquired the equity securities of B on a basis equal to that of other shareholders of A and has obtained no advantage by reason of such acquisition which is not available to all of the other shareholders of A. Therefore, the desirability of precluding such insider from making a subsequent sale of the securities of B in order to implement the purposes of section 16(b) is rather doubtful. On the contrary, one of the questionable consequences of imposing liability under section 16(b) to this combination of securities transactions would be to deter—or at least delay—insiders of A from becoming insiders of B upon the reorganization despite the fact that such deterrence may be inconsistent with the legitimate corporate objectives sought to be achieved by the reorganization.  

When dealing with the question of matching transactions in the securities of an issuer involved in a reorganization, the analysis of the two prototype illustrations in terms of their susceptibility to abuse by insiders of inside information furnishes substantial support for the adoption of a rule by the SEC exempting the acquisition or disposition of equity securities incident to a corporate reorganization from the operation of section 16(b), provided, however, that the

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exemption should not be available where there has been a purchase or sale of the equity securities of A prior to the reorganization plus a sale or purchase of the equity securities of B after the reorganization (or vice-versa), all within a six-month period. Subject to this proviso, this exemption would be consistent with the purposes of the statute and would avoid unintended liabilities. In addition, the proposed rule should only exempt securities transactions incident to a reorganization where the only securities of B that are acquired consist of equity securities. To the extent that cash or non-equity securities are acquired in connection with the organization, a profit may be deemed to have been realized for purposes of the proposed rule. Thus, the existence of some "boot" would not destroy the availability of the entire exemption; and the exemption would remain available to the extent that such profit had not been realized.\footnote{56}

By reason of state statutory requirements and, in certain instances, the requirements imposed upon listed companies by the various national securities exchanges,\footnote{7} these corporate reorganizations (except for a voluntary exchange of securities of A solely for securities of B) typically require shareholders' approval;\footnote{57} and all of such reorganizations do no involve any change in the proportionate equity interests of insiders in relation to other shareholders of that same corporation. Moreover, since section 16(b) is only applicable to issuers who are also required to comply with the Commission's proxy rules under section 14 of the Exchange Act,\footnote{9} and since such proxy rules require comprehensive disclosure concerning the terms of such reorganization, the shareholders of A (and, in many cases, the shareholders of B as well) will usually be furnished with adequate information concerning the material provisions of the corporate reorganization to enable them to make an informed determination whether to vote in certain transactions from § 16(b), see Kramer, An Examination of Section 16(b), 21 Bus. Law. 183 (1965). See also discussion in Meeker & Cooney, The Problems of Definition in Determining Insider Liabilities Under Section 16(b), 45 Va. L. Rev. 949, 971-75 (1959).

\footnote{56} This treatment of the receipt of cash and/or non-equity securities under the proposed exemptive rule is analogous to the provisions of §§ 354 and 356 of the Internal Revenue Code of 1954, as amended with respect to the receipt of "boot" in certain types of tax-free reorganizations, i.e., while the receipt of the boot is taxable, it does not destroy the tax-free character of the reorganizations specified therein.

\footnote{7} As an illustration, see New York Stock Exchange Company Manual, pp. A-284-85 (Oct. 1961). The New York Stock Exchange requires that where a corporation proposes to issue an amount of shares equal to or greater than approximately 20% of the theretofore outstanding shares of such class, it is necessary to submit the transaction for approval by shareholders to obtain the listing of such securities to be issued in connection with such transaction. In effect, this rule of the New York Stock Exchange imposes upon the issuers of listed securities a requirement of approval by shareholders regardless of the statutory requirements of the applicable state jurisdiction.


\footnote{9} Regulation 14 under the Exchange Act (17 C.F.R. § 240).
its favor. Therefore, with respect to that end of the combination of securities transactions which consists of the acquisition or disposition of a security pursuant to a corporate reorganization, the possibilities of insiders' unfair use of inside information are practically nil. If, despite the arguments in its support, the SEC were to object to promulgating the proposed exemptive rule with respect to all of the types of corporate reorganizations referred to herein, it might consider adopting the rule on a basis limited to those corporate reorganizations where, pursuant to state law or stock exchange requirements, shareholders' approval is required and where the solicitation of such approval is subject to the SEC's proxy rules.

In addition, mergers, consolidations, and exchanges of securities for assets are generally the kind of corporate transactions which are the subject of the "no sale" theory under rule 133 of the Securities Act of 1933, as amended. They involve what are essentially "corporate acts" binding upon the insider and all other shareholders whose only remedy, if they disapprove of the transaction, consists of exercising statutory rights of appraisal. The SEC, however, has apparently rejected the application of the "no sale" theory under rule 133 to the question of liability under section 16(b); but since these reorganizations do involve "corporate acts" binding upon shareholders rather than individual securities transactions by insiders, the analogy appears valid, and it is legitimate to inquire why the "no sale" theory of rule 133 must be restricted solely to the question of exemption from registration of securities under the Securities Act. In this respect, the restrictions in rule 133, which are designed to curb abuses arising from subsequent unregistered distributions of securities issued pursuant to reorganization, have their analogue in the restrictions upon the scope of the proposed rule exempting securities transactions incident to such reorganizations from section 16(b) liability. Furthermore, even though the rationale underlying rule 133 does not square entirely with the voluntary exchange of shares by the shareholders of A for the shares of B, nevertheless, as a practical matter insiders—and particularly insiders who are not controlling shareholders—often are not in a position effectively to object to a proposed transfer of shares by the shareholders of A in exchange for the shares of B. In terms of like

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60 17 C.F.R. § 230.133.
61 77 U.S.C. § a-bb. This statute is hereinafter referred to as the "Securities Act."
63 Id. at 526-27. As Professor Loss has noted therein, the SEC's amicus brief in the Hodgkinson case argued for the non-applicability of the "no sale" theory to actions under § 16(b). The Court's opinion in the Hodgkinson case makes no reference to that theory.
64 See Rule 133(b), (c), (d), 17 C.F.R. § 230.133(b), (c), (d).
treatment among all shareholders and resulting business consequences, a voluntary exchange of securities stands on the same ground as the other forms of reorganizations and there appears to be no warrant for excluding such exchanges of securities—which are often selected as the form for effecting the transaction to serve technical corporate or federal tax purposes which are irrelevant to the purposes of section 16(b)—from the scope of the proposed exemption.

Moreover, the imposition of liability under section 16(b) to a combination of transactions which includes the acquisition or disposition of an equity security incident to a corporate reorganization may hinder the insider, by threat of such potential liability, from acting solely in the interests of the corporation and its shareholders. Insiders often have the power to prevent or delay the consummation of any corporate reorganization, and they should not be placed in a position where, to avoid section 16(b) liability, they must delay the securities transaction incident to the reorganization beyond the statutory six-month period. An exemption of the acquisition or disposition of the equity security upon the reorganization from the operation of section 16(b) would eliminate the possible breaches of fiduciary duty which might otherwise ensue by reason of continuing to subject such transactions to section 16(b) liability.

Finally, it should also be noted that if an insider has actually used inside information in purchasing or selling the equity securities of either A or B prior to or after the date of reorganization, there are presently adequate remedies available to hold such insider liable for his breach of fiduciary duty in connection with such insider's purchase or sale of securities. Since the purpose of section 16(b) is restricted to an attack upon a combination of purchase and sale involving the possibility of unfair use of inside information, its coverage should not be extended in a manner beyond, and perhaps inconsistent with, this specific purpose, particularly where such other remedies are readily available.

What has been stated herein respecting corporate reorganizations

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65 17 C.F.R. § 240.10b-5. The language of rule 10b-5 is largely patterned after the language of § 17, 15 U.S.C. § 77(Q), of the Securities Act with respect to misrepresentations and material omissions. The most significant distinction between rule 10b-5 under the Exchange Act and § 17 of the Securities Act is that the rule covers sellers of securities as well as purchasers of securities. The civil liability implied from rule 10b-5 has resulted in a large number of decisions rendered by the federal courts and has also resulted in substantial recoveries by defrauded purchasers and sellers of securities who have placed reliance upon rule 10b-5 rather than upon the more circumscribed express civil remedies contained in the Securities Act. For an interesting discussion of the implications of the development of law under rule 10b-5, see Fleischer, "Federal Corporation Law": An Assessment, 78 Harv. L. Rev. 1146 (1965).

66 See text accompanying note 31 supra.
Reclassifications, which generally require shareholders' approval, are frequently undertaken to recapitalize the issuer in order to meet corporate financial requirements or, more specifically, with a view to a public offering of the issuer's securities. As in corporate reorganizations, the laws of the applicable states typically contain sufficient statutory safeguards to insure that all shareholders of the same class are treated alike with respect to the securities exchanged upon such reclassifications. The holding in Roberts v. Eaton, where the reclassification was admittedly undertaken with a view to a public offering of the securities of the issuer shortly thereafter, should be incorporated into the exemptive rule proposed herein.

Apart from the considerations which, upon analysis, would indicate that the acquisition or disposition of securities pursuant to a reorganization ordinarily do not entail risk of speculative abuse, there is one additional consideration which further supports arguments in favor of the proposed exemptive rule. By reason of the amendment by the SEC of rule 16b-9, there is presently a disparity in the treatment accorded insiders who convert their securities, but who may have purchased the convertible security or sold the security within six months from the date of such conversion, as opposed to insiders who acquire or dispose of an equity security incident to a reorganization and who now can neither purchase nor sell the securities of either A or B within six months from the date of consummation of such reorganization. It is indeed questionable whether this disparity is justified, particularly in view of the fact that, except in the case of a forced conversion, an insider's decision to convert securities may be made solely on the basis of his personal financial considerations and regardless of action by other shareholders; whereas the decision to acquire or dispose of securities pursuant to a reorganization involves corporate action by directors and shareholders upon which the insider may have limited influence. The proposed exemptive rule would effectively eliminate this disparity of treatment.

The considerations set forth above should not be construed as implying that there are no areas involving the acquisition or disposition of equity securities pursuant to a corporate reorganization where the possibility of speculative abuse is not genuine. Such possibilities, however, are restricted to instances where there has been a purchase or sale

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88 212 F.2d 82 (2d Cir. 1954).
of the equity securities of A prior to the reorganization plus a sale or purchase of the equity securities of B after the reorganization (or vice versa), resulting in a realized profit, all within a six-month period. In this type of situation, it can be demonstrated that real possibilities of speculative abuse exist with respect to both sides of the transaction. Accordingly, as noted above, any rule to be adopted by the SEC should specifically restrict its application so as to exempt from the operation of section 16(b) only an acquisition or disposition of an equity security incident to a corporate reorganization where there has not been a combination of such sale and purchase of the equity securities of A and B within a six-month period, including the date of consummation of the reorganization. In effect, such rule should contain restrictions analogous to those contained in amended rule 16b-9 exempting conversions and rule 16b-7(c) exempting acquisitions or dispositions of securities pursuant to reorganizations involving eighty-five per cent owned subsidiaries.\(^9\)

The substance of the rule proposed herein has heretofore been recommended by the securities bar, but thus far the SEC has failed to adopt it. If, despite the arguments advanced herein and the suggested limitations upon the proposed rule, the SEC is of the view that exempting from section 16(b) all acquisitions and dispositions of equity securities incident to a reorganization would not be appropriate because of the possibility of speculative abuse, particularly insofar as a purchase of equity securities of A, or a sale of such securities of B, prior to the reorganization are concerned (i.e., the facts of the first prototype illustration above), then it should at least consider the adoption of a rule which would exempt from the operation of the statute the acquisition pursuant to the reorganization of equity securities of B when followed by a subsequent sale of such securities within six months thereafter. For the reasons pointed out under the second prototype illustration, the acquisition of equity securities of B incident to a reorganization does not appear to involve the possibility of abuse of inside information prior to its consummation; and if such securities are sold within six months after the date of such reorganization, but

\(^9\) Rule 16b-7(c) restricts the exemption provided for acquisitions or dispositions of securities pursuant to reorganizations among affiliated companies. The substance of rule 16b-7 is set forth in note 52 supra. The restriction under rule 16b-7(c) removes from the scope of such exemption from § 16(b) transactions by an insider involving the purchase (other than an acquisition pursuant to the reorganization) of a security of one of the companies which are parties to the reorganization plus the sale (other than the disposition of a security pursuant to such reorganization) of another company which is a party to such reorganization within any six month period during which such reorganization takes place. This restriction upon the exemption for securities transactions involving reorganizations of affiliated companies parallels that which is now set forth in amended rule 16b-9 and the exemptive rule proposed in this Article.
more than six months after the date upon which the equity securities of A were purchased prior to such reorganization, it is difficult to discern how the purposes of section 16(b) are implemented by subjecting the insider to liability by reason of such subsequent sale. This limited alternative rule would at least serve the purpose of relieving insiders from the harsh and questionable results reached in the Hodgkinson and Marquette Cement cases.

**DETERMINATION OF PURCHASE PRICE OF SECURITIES RECEIVED IN CORPORATE CONVERSIONS AND REORGANIZATIONS**

Where section 16(b) liability is imposed upon an insider for securities transactions arising out of a corporate reorganization or a conversion, determining the profit recoverable by the issuer may entail difficulties often encountered in measuring the value of the securities or assets exchanged or received. The statute speaks in terms of "profit realized," and the Second Circuit's holding of this language in Smolowe v. Delendo Corp. has established a central precedent for interpretation of this statutory language. In the Smolowe case, the court held that, in order to implement the remedial purposes of section 16(b), profits shall be so computed as to squeeze out all possible profits from any series of transactions. Thus, the Second Circuit stated its rule for determining realized profit to be that of "lowest in, highest out" within any six-month period. This would still hold even though the matching of specific purchases and sales (e.g., by way of tracing actual certificates, the "FIFO" method, or otherwise) might have resulted in an actual loss to the insider.

The courts, taking due note of the Smolowe doctrine, have arrived at varying methods of valuation in conversion, reorganization and reclassification situations. Such methods of determining the purchase price of securities are illustrated by the following table of cases, which also sets forth the dates selected by the courts upon which such determination is to be made:

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72 136 F.2d at 239.
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<td>(2d Cir. 1947).</td>
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* Where market value of convertible preferred is difficult to determine, use market value of common to be obtained upon conversion, per dissent of Swan, J. in Park & Tilford v. Schulte, 160 F.2d 984, 991 (2d Cir. 1947), cert. denied, 332 U.S. 761 (1947), which was apparently followed in Babbitt v. Lachner.

**Heli-Coil v. Webster**, 352 F.2d 156 (3d Cir. 1965).


Conversion of preferred into common & subsequent sale of common

Conversion of debentures into common & subsequent sale of common**

Exchange of shares between shareholder of A and B and subsequent sale of B shares

Market value of preferred (implied)

Conversion date (implied)

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Sale of assets of A in exchange for shares in B and subsequent sale of shares of B

Sale of assets of A for shares of B followed by dissolution of A to its shareholders who subsequently sold shares of B

Value of assets given up by A

"The market price of (B's) shares at the time of the purchase is some evidence, therefore, of the assets exchanged for them." 132 F. Supp. 100, 107. (Emphasis added.)

General principle is value consideration given up on exchange, but since value of shares given up difficult to ascertain, court used value of shares of B at their lowest price such shares sold at on date of value, citing the Smolowe case

Date of consumption of exchange

The closing date was held to be the date of irrevocable legal liability to exchange assets since the contract of sale allowed the defendant to terminate the agreement if it were unable to obtain the necessary financing

Date of dissolution of A—i.e., date upon which shareholder became irrevocably committed legally to take shares of B—i.e., prior to date of actual receipt of shares

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**Third Circuit refused to impose liability under § 16(b) with respect to matching of conversion (i.e., "sale") with prior purchase of convertible debentures.**

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exchange of common shares of A for preferred shares of B incident to merger and subsequent conversion into common shares of B

market value of shares of A;
value of common shares of B received on conversion

date of exchange of shares;
date of conversion of preferred shares of B.

*** The district court's decision was reversed on other grounds by the Second Circuit in Blau v. Lamb, CCH Fed. Sec. L. Rep. ¶ 91,710.
From this line of cases, both within and outside of the conversion and corporate reorganization areas, one can draw fairly reliable conclusions with respect to the question of determining the purchase price of securities for section 16(b) purposes.

The value of the consideration given shall, as a general rule, determine the purchase price of the securities received. Accordingly, the value of the shares or assets of A which are exchanged for the securities of B is likely to be relied upon by the courts in establishing the purchase price for the determination of recoverable profit. The same approach may also be deemed applicable to the determination of the "purchase" price of the underlying security issued upon conversion of the convertible security.

Where, as illustrated in the Babbitt, Graham-Paige and Marquette Cement cases, the market value of the securities or assets of A is difficult to determine, the courts are likely to resort to a valuation of the securities of B received upon the acquisition. This problem will normally be encountered where the securities of A are not actively traded and it assumes, of course, that the securities of B have a readily ascertainable market value. In most instances, since section 16(b) is only applicable to issuers whose equity securities are either listed on a national securities exchange or are registered under section 12(g) of the Exchange Act, the securities of B are likely to have a readily ascertainable market value.

In order to implement the Smolowe doctrine, which is designed to squeeze out as much recoverable profit as possible from an insider's securities transactions, it is most likely that the courts will select the lowest sale price of the securities of A on the valuation date in establishing the purchase price for the securities of B. A recent illustration of this approach appears in the Marquette Cement case.\(^{72}\)

In computing recoverable profit under section 16(b), the courts will probably include dividends received by the insider between the date of his acquisition of the securities of B and the date upon which he subsequently sells such securities. In Western Auto Supply v. Gamble Skogmo, Inc.\(^{74}\) and the Marquette Cement case the courts included the amount of dividends actually received between the dates of purchase and sale in computing the insiders' profits.\(^{75}\) As a corollary,
where the insider subject to section 16(b) has made a sale followed
by a purchase of the securities of B, dividends declared and paid by
B prior to the date of such subsequent purchase will apparently be
deducted in computing realized profit.78

SELECTING THE DATE OF PURCHASE AND
VALUATION IN CORPORATE REORGANIZATION

In the area of corporate reorganizations, the question of which
date is to be selected (for determining the purchase price of the secur-
ities and also for determining the date upon which such purchase has
occurred) is of considerable significance in imposing section 16(b)
liability. This question will remain significant even if the SEC adopts
the rule recommended herein which would exempt acquisitions or
dispositions of securities pursuant to reorganizations. As indicated in
the table of cases set forth above, the principles which the courts
have relied upon in selecting a date are not susceptible to simple
restatement. In cases involving conversion of securities, the courts
have selected the date of conversion as appropriate for both pur-
poses. However, with respect to reorganizations, the courts have, as
indicated in the above table, thus far arrived at varying, and seem-
ingly inconsistent, results. There may be some justification for em-
ploying different criteria when applying section 16(b) to different
types of corporate reorganizations. However, it would appear that,
regardless of the form of reorganization, one rule should guide the
courts in selecting the date of purchase because the securities trans-
actions pursuant to all of such reorganizations involve the same con-
siderations from the standpoint of section 16(b). It would also appear
that the date to be selected should be that date upon which the in-
sider becomes irrevocably bound and committed to acquire the secur-
ities pursuant to the reorganization, or, in other words, the date upon

grounds, 208 F.2d 600 (2d Cir. 1953).
which the insider's rights and obligations have been fixed with respect to such acquisition. The merit in this approach is that it would relate the date of purchase to substantive, as distinguished from procedural or ministerial, considerations in determining when the insider has in fact made his decision to acquire the securities of B. If this criterion is applied, it should, in the absence of unusual circumstances, result in the following determinations of the purchase date in the following types of corporate reorganizations:

(1) Where the reorganization involves a voluntary exchange of shares between the shareholders of A and B, the date upon which such exchange has been consummated should constitute the purchase date. To select the date upon which the insider has entered into an agreement to transfer his shares (a date which typically occurs prior to the consummation of such exchange) is unrealistic since such agreements are invariably subject to material substantive closing conditions prior to or following such agreement, and therefore the agreement date is an unjustifiably arbitrary one.

(2) If the reorganization involves an exchange of assets of A for the securities of B which is followed by a liquidation of A, then the date of purchase for section 16(b) purposes should be the date of liquidation of A. The date of liquidation of A appears appropriate because until such date the insider will not have become legally bound to acquire the securities of B. While it is true that the insider may have sufficient control of A to delay the date of liquidation of A beyond the six-month period, prior to such date it remains uncertain whether the insider will receive the securities of B upon such liquidation. In this respect, the holding in the Marquette Cement case seems correct. This suggested rule is subject to one caveat. Where A itself becomes the insider of B by reason of A's acquisition of more than ten per cent of a class of equity securities of B pursuant to the reorganization, then the appropriate date for section 16(b) purposes would appear to be the date of consummation of the exchange of A's for B's securities. Prior to that date, any contract to effect such ex-

78 In Fistel v. Christman, 135 F. Supp. 830-31 (S.D.N.Y. 1955), the district court, without discussing the point, selected the date of sale of the shares as the date for determination of the fair market value of such shares in a case involving a voluntary exchange of securities.
79 Significantly, under § 337 of the Internal Revenue Code of 1954, as amended, a corporation which has adopted a plan of complete liquidation has twelve months within which to sell its assets, and to liquidate without incurring tax liability on the corporate level for gain derived from the sale of such assets within such twelve month period. This federal income tax statutory provision is one among several factors which furnish insiders with the opportunity to delay the liquidation of the corporation after it has consummated the sale of its assets in exchange for securities of another corporation.
change would normally be subject to material closing conditions which would leave uncertain the legal obligation of A to acquire these securities. This approach is consistent with the holding of the court in *Stella v. Graham-Paige Motors Corp.*

(3) If the reorganization takes the form either of a statutory merger or consolidation, then the date of purchase should be deemed to be that date upon which such merger or consolidation has actually been consummated. This recommendation is based upon the fact that, apart from the technical consideration that such transactions are not deemed legally to have been accomplished until the articles or certificates of merger or consolidation have been properly filed pursuant to the requirements of the states of incorporation of both A and B, the standard agreement of merger or consolidation is subject to numerous material conditions, including approval of shareholders, prior to consummation. Until such date, therefore, the shareholders of A should not be deemed to have acquired the securities of B pursuant to such merger or consolidation for section 16(b) purposes.

The above recommended dates of valuation for section 16(b) purposes in paragraphs (2) and (3) are subject, however, to the qualification that, depending upon the laws of the applicable jurisdiction, any insider who has not voted his securities in favor of the acquisition should not be deemed to have "purchased" the securities of B until such date as his statutory right of appraisal under state law shall have, in fact, expired.

It is to be noted that the approach recommended herein differs from the holding in the *Hodgkinson* case. While not entirely clear, it appears that the Court in the *Hodgkinson* case held that the date of purchase for section 16(b) purposes was the date upon which the insider surrendered certificates evidencing the shares of A subsequent to the liquidation of the subsidiary into its parents. The *Hodgkinson* result seems hypertechnical since utilizing the date upon which certificates evidencing the securities are surrendered or received would not appear significant for selecting either the date of valuation of the purchase price of the securities or whether such date is within the six-month period under section 16(b). In this respect, the holding in *Marquette Cement*, by selecting the date of dissolution of A on the ground that upon such date the insider (a shareholder of A) was legally bound to acquire the securities of B received by A pursuant to

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the reorganization," probably represents a better approach to the question.

**Conclusion**

The application of section 16(b) to reorganizations, and reclassifications has therefore created a condition of uncertainty which is contrary to the public interest. The courts have struggled with the statutory definitions of "purchase" and "sale" and have frequently adopted tortuous reasoning in order to avoid harsh results. It is evident that clear rules of general application, upon which insiders and their counsel can rely, are unlikely to be forthcoming from the courts. The logical solution to this problem is that the SEC use its exemptive and interpretative powers to adopt a rule of general application and clear understanding similar to the recent amendment to rule 16b-9.

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