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INSIDERS' LIABILITIES
UNDER THE SECURITIES EXCHANGE ACT OF 1934

by

Roy L. Cole*

WHILE there was a considerable drive toward corporate law reform in the 1910's and 1920's, the stock market crash of 1929 and the ensuing depression provided the ultimate impetus to the enactment of the Federal Securities Act of 1933,¹ the Securities Exchange Act of 1934,² and the other acts which make up the body of federal securities regulation.³ The Securities Act of 1933 was passed to protect the public against losses through unethical and dishonest practices on the part of persons and corporations selling newly-issued securities.⁴ It was followed in 1934 by the Securities Exchange Act, which was primarily concerned with the regulation of stock trading rather than initial distribution, and was intended to require the dissemination of at least a minimum amount of information to persons who buy and sell securities, to regulate the securities markets, and to control the amount of the nation's credit channeled into those markets.⁵

As stated in the 1934 report of the Senate Banking and Currency Committee, which shortly preceded the passing of the Securities Exchange Act:

Among the most vicious practices unearthed at the hearings before the subcommittee was the flagrant betrayal of their fiduciary duties by

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¹ 48 Stat. 74, 15 U.S.C.A. §§ 77a-77aa (1951).

² 48 Stat. 881, 15 U.S.C.A. §§ 78a-78jj (1951).

³ The other acts in the series are: Public Utility Holding Company Act of 1935, 49 Stat. 838, 15 U.S.C.A. §§ 79-79z-6 (1951); Trust Indenture Act of 1939, 48 Stat. 95, 15 U.S.C.A. §§ 77aaa-77bbb (1951); Investment Company Act of 1940, 54 Stat. 847, 11 U.S.C.A. §§ 72-107 (1946); — Stat. —, 15 U.S.C.A. §§ 80a-1-80a-52 (1951); Investment Advisers Act of 1940, 54 Stat. 852, U.S.C.A. §§ 80b-1—80b-21 (1951); Chandler Act, 52 Stat. 840 (1938); 11 U.S.C.A. §§ 501-676 (1941). For a detailed background of the securities statutes, see Loss, *Securities Regulation* 56-105 (1951).

⁴ Address by President Roosevelt, March 29, 1933, S. Rep. No. 47, 73d Cong., 1st Sess. 6-7 (1933); H. R. Rep. No. 85, 73d Cong., 1st Sess. 1-2 (1933).

⁵ Loss, *op. cit.* supra note 3, at 84.

directors and officers of corporations who used their positions of trust and the confidential information which came to them in such positions, to aid them in their market activities. Closely allied to this type of abuse was the unscrupulous employment of inside information by large stockholders who, while not directors and officers, exercised sufficient control over the destinies of their companies to enable them to acquire and profit by information not available to others.⁶

To curb the abuses referred to, at least in part, section 16 was incorporated into the Securities Exchange Act.⁷ Section 16(a) requires that each beneficial owner of more than ten per cent of any class of equity security of a company having an equity security registered on a national securities exchange, and every person who is a director or officer of such a company, file (at the time of the registration of such security or within ten days after such person becomes a beneficial owner, director or officer) a statement of his ownership of all classes of equity securities of the issuer; it further provides that such person must give monthly reports of all changes in his ownership of such equity securities thereafter. This subsection is grounded on the premise that persons in position to obtain large profits from stock manipulations because of their "insider" status in the corporation will discontinue their manipulations if forced to publicize them.

Section 16(b) provides that any profit realized by a director, officer, or beneficial owner of more than ten per cent of any class of equity security of a company having an equity security registered on a national exchange, which profit is realized from any purchase and sale or any sale and purchase of any equity security of his company within any period of less than six months, must be paid over to the company of which the profiteer is a director, officer, or beneficial owner. The idea behind section 16(b) is, of course, that if one cannot retain the profits from transactions based on his peculiar knowledge of a company's affairs, he will not engage in such transactions.

Section 16(c) prohibits short sales by insiders and likewise prohibits insiders from "selling against the box," that is, selling securities and then borrowing like securities to meet the commitment, in the hope of later replacing the borrowed securities at a lower price.

The Securities Exchange Commission has issued a number of rulings under subsections (a) and (c), but has never attempted to apply the criminal sanctions of subsection (c). The most important

⁶ S. Rep. No. 1455, 73d Cong., 2d Sess. 2-3 (1934).

⁷ June 6, 1934, c. 404, § 16(b), 48 Stat. 896; 15 U.S.C.A. § 78p(b) (1951).

deterrent to prevent insiders from making use of their connections to obtain personal profits at the expense of investors not having access to such information, is section 16(b).⁸

For almost ten years after the Securities Exchange Act was passed there was no litigation under section 16. But the next similar period saw the establishment of a great many principles applicable to insiders' profits. The most significant cases were *Smolowe v. Delendo Corp.*,⁹ *Park & Tilford, Inc. v. Schulte*,¹⁰ *Truncala v. Blumberg*,¹¹ and *Shaw v. Dreyfus*¹² in the substantive field; *Gratz v. Claughton*,¹³ the *Park & Tilford* case, *Twentieth Century-Fox Film Corp. v. Jenkins*,¹⁴ *Grossman v. Young*,¹⁵ *Benisch v. Cameron*,¹⁶ and *Arbetman v. Playford*¹⁷ were significant in the procedural area. The *Park & Tilford*, *Dottenheim*,¹⁸ and *Berkey & Gay*¹⁹ cases established a rule for the allowance of attorney's fees to the complaining stockholder out of the funds recovered on behalf of the corporation; and *William F. Davis, Jr.*,²⁰ apparently established a firm rule that the insider forced to disgorge profits from short-swing transactions in his company's stock can not obtain the benefits of an income tax deduction for such repayments.

⁸ Section 16(b) of the Securities Exchange Act of 1934 provides:

"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."

⁹ 136 F.2d 231 (2d Cir.), cert. denied, 320 U.S. 751 (1943).

¹⁰ 160 F.2d 984 (2d Cir.), cert. denied, 332 U.S. 761 (1947).

¹¹ 80 F. Supp. 387 (S.D.N.Y. 1948).

¹² 172 F.2d 140 (2d Cir.), cert. denied, 337 U.S. 907 (1948).

¹³ 187 F.2d 46 (2d Cir.), cert. denied, 341 U.S. 920 (1951).

¹⁴ 7 F.R.D. 197 (S.D.N.Y. 1947).

¹⁵ 70 F. Supp. 970 (S.D.N.Y. 1947).

¹⁶ 81 F. Supp. 82 (S.D.N.Y. 1948).

¹⁷ 83 F. Supp. 335 (S.D.N.Y. 1949).

¹⁸ *Dottenheim v. Emerson Elec. Mfg. Co.*, 7 F.R.D. 195 (E.D.N.Y. 1947).

¹⁹ *Berkey & Gay Furniture Co. v. Wigmore*, Civil No. 40-147, S.D.N.Y. 1947.

²⁰ 17 T.C. 549 (1951).

While these cases will be discussed under the appropriate headings, they have been well and exhaustively treated heretofore,²¹ and the emphasis of this paper will be on subsequent developments.

I. GENERAL OBJECTIVES, CONSTITUTIONALITY, AND COVERAGE

Although section 16(b) is at best a crude and limited device for preventing insiders from misusing their special corporate information,²² the courts have almost without exception construed it as broadly as possible. In the first decided case, *Smolowe v. Delendo Corp.*, the Second Circuit set a broad pattern of liberal interpretation to effectuate congressional intent which has prevailed ever since. In holding that section 16(b) requires an insider to turn over profits from short-swing dealings²³ to the corporation regardless of whether or not in the particular instance he had made use of any private information obtained by virtue of his connection with the corporation, the court said that the fact that bona fide transactions might be caught in the net of the statute could not affect the right of Congress to strike at the tendency to evil in other cases by an imposition of an absolute rule of turning over profits in every case. The court quoted with approval the language of the United States Supreme Court in *SEC v. Chenery Corp.*²⁴ (a case dealing with the Public Utility Holding Company Act) as follows:

Abuse of corporate position, influence, and access to information may raise questions so subtle that the law can deal with them effectively only by prohibitions not concerned with the fairness of a particular transaction.²⁵

The court rejected the defendant's contention that section 16(b) would not apply to a situation where an insider acquires a certifi-

²¹ See particularly Cook and Feldman, *Insider Trading Under The Securities Exchange Act*, 66 Harv. L. Rev. 385, 612 (1953). Also see Rubin and Feldman, *Statutory Inhibitions Upon Unfair Use of Corporate Information by Insiders*, 95 U. of Pa. L. Rev. 468 (1947); Comment, 27 Texas L. Rev. 840 (1947). Since its publication the Cook and Feldman article in the Harvard Law Review has been cited in most § 16(b) cases.

²² For example, § 16(b) covers only buy and sell (or sell and buy) transactions completed within a six-months' period. It cannot touch the situation where the insider purchases securities and disposes of them six months and one day later, or the converse situation where the insider sells securities and does not repurchase until six months and one day later. Nor does it attempt to cover the situation where the insider gives "tips" to members of his family who make profits by use of the information, nor a situation where insiders of two companies exchange information, with each making a profit by use of the information in transactions in the other's stock.

²³ "Short-swing profits" are those required by the act to be paid over to the corporation—that is, profits made on purchases and sales, or sales and purchases, completed within a six-months' period.

²⁴ 318 U.S. 80 (1943).

²⁵ 136 F.2d 231, 240 (1943).

cate for 100 shares of stock, waits six months and acquires a certificate for another 100 shares of stock, then on the next day sells the shares represented by the first certificate. Such a ruling would completely emasculate the statute, since:

Under the basic rule of identifying the stock certificate, the large stockholder, who in most cases is also an officer or director, could speculate in long sales with impunity merely by reason of having a reserve of stock and upon carefully choosing his stock certificates for delivery upon his sales from this reserve. Moreover, his profits from any sale followed by a purchase would be practically untouchable, for the principle of identity admits of no gain without laboring proof of a subjective intent—always a nebulous issue—to effectuate the connected phases of this type transaction. In consequence the statute would be substantially emasculated. We cannot ascribe to it a meaning so inconsistent with its declared purpose.²⁶

Park & Tilford, Inc. v. Schulte reaffirmed the constitutionality of section 16(b) and its effectiveness to require the payment to the corporation of all short-swing profits irrespective of whether such profits were or were not made through the use of inside information.

The next Second Circuit case involving section 16(b) was *Gratz v. Claughton*. While most important for its pronouncements on procedural matters, the court for the third time affirmed the constitutionality of section 16(b), reaffirmed the holding of the *Smolowe* case that transactions need not be matched by identifying the shares dealt in, and established the rule that, for purposes of pairing sales and purchases, a sale may be matched against any purchase at a lower price within six months before the sale or within six months afterwards.²⁷

In one of the comparatively rare section 16(b) decisions arising outside of the Southern District of New York,²⁸ *Walet v. Jefferson Lake Sulphur Co.*,²⁹ the Fifth Circuit dealt with an admitted \$36,000.00 short-swing profit made by the company's president. In

²⁶ *Id.* at 238.

²⁷ The defendant had insisted that, in applying the six-month limitation of § 16(b), any given sale could only be matched with a purchase no more than three months preceding or three months after the sale. In regard to the effect of its overruling the defendant's contention, the court said: "It is true that this means that no director, officer, or 'beneficial owner' may safely buy and sell, or sell and buy, shares of stock in the company except at intervals of six months. Whether that is too drastic a means of meeting the evil, we have not to decide; it is enough that we can find no other way to administer the statute." 187 F.2d 46, 52 (1951).

²⁸ Under § 27 of the act, a § 16(b) action may be brought in the district wherein "any act or transaction constituting the violation" occurs. Since most sales and purchases of listed stocks take place on Manhattan exchange floors, the overwhelming majority of § 16(b) cases are filed in the courts of the Southern District of New York. See also *Gratz v. Claughton*, *supra*.

²⁹ 202 F.2d 433 (5th Cir.), cert. denied, 346 U.S. 820 (1953).

November of 1950, the defendant acquired 1,200 shares of treasury stock pursuant to an option granted to him for "extraordinarily meritorious services." His profits during the following six months were from the sale of shares other than those acquired pursuant to the option. In affirming the president's liability to pay his profits over to the corporation, the Fifth Circuit followed *Gratz v. Clagh-ton* and *Smolowe v. Delendo Corp.*, rejecting the defendant's claim of non-liability based on his complete good faith, the absence of any inside information, and the fact that the sales were of different shares from those purchased. However, the *Walet* case is important not only in being a fresh decision from another circuit following the *Gratz* and *Smolowe* cases, but in extending the views expressed by the Second Circuit and securing for section 16(b), as far as permissible under the statutory language, a far-reaching power to effectuate the broad equitable purposes of Congress.

First, the court rejected defendant's contention that only one-half of any profits were repayable to the corporation since the other half was realized, under the community property laws of Louisiana, not by him but by his wife. It was pointed out that in Louisiana the husband is the head and master of the community and as such must be held accountable for his management thereof, and further that "any other rule would defeat the purpose of the statute here under consideration, at least in part, in community-property states. In such circumstances, Federal policy must prevail over the vagaries in local laws."³⁰

Next the court rejected the defendant's argument that treasury shares are not "equity securities" and thus not within the provisions of section 16(b). This argument was based upon the fact that treasury shares are specifically included in the statutory definition of "security"³¹ but omitted from the definition of "equity security."³² In disposing of this contention the court said:

We think this omission lacks the significance that the appellant would attribute to it. Included in the definition of 'equity security' is the generic phrase 'stock or similar security,' which embraces treasury stock; and, in any event, treasury stock by the very fact of its purchase and issuance ceases to be such and becomes outstanding or non-treasury stock.³³

Finally, the court held in *Walet* that not only is it no defense that the defendant acts in the utmost good faith, without any inside in-

³⁰ Id. at 434, citing *Wissner v. Wissner*, 338 U.S. 655 (1950).

³¹ Securities Exchange Act of 1934, supra note 2, at § 3(a)(10).

³² Id. at § 3(a)(11).

³³ 202 F.2d 433, 435 (1953).

formation whatsoever, and without any damage to the company or its stockholders as a result of his acts, but also that a corporation, by granting an option to an employee or director for extraordinarily meritorious services, cannot thereby be held to have waived the benefits of section 16(b) in the event that the option is exercised and the officer or director obtains a profit with respect to the same or similar shares sold within six months after the exercise.

All three of these principles enunciated in *Walet* seem completely justified and entirely consistent with the congressional purpose underlying the Securities Exchange Act; indeed, contrary holdings would severely restrict the accomplishment of the purposes for which section 16(b) was enacted.

In *Pellegrino v. Nesbit*,³⁴ the Ninth Circuit had occasion to consider a claimed estoppel situation. Consolidated Engineering Corporation had granted stock options to three officers. Later the corporation's president, when informed by the optionees that they were financially unable to exercise the options and purchase the stock without concurrently selling a portion of the purchased stock to pay for the stock retained, told the optionees that they could effect sales of a portion of their stock through a brokerage house of which one of the directors of the corporation was a partner. The Ninth Circuit held that the plea of estoppel against the corporation to claim the profits from the sales could not stand.³⁵

The defense of estoppel against the corporation in section 16(b) actions should have been finally laid at rest by the Second Circuit's decision in *Magida v. Continental Can Co.*³⁶ There the sale complained of was made by the defendant, the majority stockholder of the corporation, at the corporation's special request. The corporation so requested because the defendant's majority stock ownership was embarrassing the corporation in its sales efforts with competitors of defendant, and the corporation was afraid that its stock would be delisted by the exchange because of too few outstanding shares available for trading. As a result of this request the defendant sold a large block of the corporation's stock, overlooking the fact that he

³⁴ 203 F.2d 463 (9th Cir. 1953).

³⁵ The court relied in general on *Scott Paper Co. v. Marcalus Mfg. Co.*, 326 U.S. 249 (1945), where the Supreme Court said at p. 257: "For no more than private contract can estoppel be the means of successfully avoiding the requirements of legislation enacted for the protection of a public interest." With particular reference to the Securities Act the court relied on the district court decision in the *Walet* case, 104 F. Supp. 20 (E. D. La. 1952), and upon *Blau v. Hodgkinson*, 100 F. Supp. 361 (S.D.N.Y. 1951), in which latter case it was held that settlement of a claim for short-swing profits by the corporation was not a bar to a later suit instituted or prosecuted by a corporate shareholder under § 16(b).

³⁶ 231 F.2d 843 (2d Cir.), cert. denied, 351 U.S. 972 (1956).

had purchased a much smaller block of stock within the previous six months. The defendant denied liability on the grounds that he had acted in good faith, had merely overlooked the earlier purchase, and had not made use of inside information. The court, relying on *Gratz v. Claughton* and *Smolowe v. Delendo Corp.*, rejected those defenses, and specifically rejected estoppel as a defense to section 16(b) action under any circumstances, saying:

Since the policy of the statute is to protect minority stockholders and the public against manipulated market fluctuations, certainly this stockholder, who became such after the acts in question had taken place, cannot be estopped by corporate acts, even those having the apparent approval of a majority of stockholders. The action under Sec. 16(b) is derivative in the sense that the corporation is the instrument, some times unwilling, for the effectuation of the statutory policy; but this so called derivative nature of the right, when coupled with the doctrine of estoppel, cannot serve to defeat the very policy it was created to advance . . . [W]e think that as a matter of law the language and purpose of the statute preclude an estoppel based upon investigation by or benefit to the corporation whose shares are traded.³⁷

a. *Immateriality of Plaintiff's Motives*

Not only is the defendant's good faith immaterial, but it has now been established that the plaintiff's motives in bringing suit are equally immaterial. The right to sue (or intervene) is absolute. In *Magida v. Continental Can Co.*, where plaintiff bought his few shares of stock after the transaction complained of in his petition and did not present his stock for registration on the company's books until after filing suit, and where defendant alleged that plaintiff's sole motive in prosecuting the action was to obtain a fee for his attorney, the Second Circuit upheld the district judge's refusal to allow amendment of defendant's answer to include the defense of champerty, saying:

But we think that, even if the proposed Fourth Defense [of champerty] were fully capable of proof, it would be insufficient in law to defeat the suit. The action is brought on behalf of the corporation to protect the rights of stockholders and of the public. The relationship between his attorney and the plaintiff who is the mere vehicle of recovery, cannot defeat the rights of the corporation and other stockholders, to whom the recovery accrues.³⁸

In *Pellegrino v. Nesbit*, the Ninth Circuit, in upholding the denial

³⁷ Id. at 846, citing the *Park & Tilford*, *Nesbit*, and *Walet* cases.

³⁸ Id. at 848, citing *Young v. Higbee*, 324 U.S. 204, 214 (1945), and *Magida v. Continental Can Co.*, 12 F.R.D. 74, 78 (S.D.N.Y. 1951).

of defendant's challenge to a motion by the holder of two shares of the corporation's stock to intervene and prosecute the action, said:

The sufficiency of the interest appellant is seeking to protect is challenged by appellees. They have emphasized that since appellant averred in his affidavit that he now owns but two shares of stock in the corporation any recovery in behalf of the corporation will result in an exceedingly small recovery applicable to appellant's stock interest. We are not convinced that this factor is significant. . . . In view of the statutory policy involved we need not be concerned with either the substantiality of appellant's shareholder interest, see *Twentieth Century-Fox Film Corporation v. Jenkins*, or appellant's motive in seeking to take part in the litigation.³⁹

To the same effect is *Blau v. Ogsbury*,⁴⁰ holding that plaintiff's motive for bringing a section 16(a) suit is immaterial in view of the legislative policy to curb short-term trading by insiders.

b. *Beneficial Ownership "at the Time of the Purchase"*

Section 16(b) provides that short-swing profits by the beneficial owner of more than ten per cent of any class of a corporation's equity securities are not covered by the section unless the beneficial owner was such "both at the time of the purchase and sale, or the sale and purchase, of the security involved."⁴¹ This wording posed the important question as to whether the purchase by which the beneficial owner acquired an interest greater than ten per cent in a class of equity security could be counted as the purchase in the "purchase and sale" necessary to complete a transaction the profits from which would be payable to the corporation under section 16(b).⁴² The SEC apparently has always held the view that both the purchase in which the ten per cent holding was acquired and the sale in which it was divested would constitute parts of a transaction falling within the coverage of section 16(b),⁴³ but the matter did not come before the courts until 1952.

³⁹ 203 F.2d 463, 466 (1956), citing *Young v. Higbee*, 324 U.S. 204 (1945), and *Magida v. Continental Can Co.*, 12 F.R.D. 74 (S.D.N.Y. 1951).

⁴⁰ CCH Fed. Sec. L. Rep. para. 90635 (S.D.N.Y. 1953), aff'd on other grounds, 210 F.2d 426 (2d Cir. 1954).

⁴¹ This limitation on coverage applies only to beneficial owners who are not also officers or directors. It is obvious from the statute that a short-swing profit of an officer or director is payable to the corporation if the person making the profit was an officer or director either at the time of the purchase or the time of the sale.

⁴² See *Cook and Feldman*, supra note 21, at 631.

⁴³ Rule X-16B-2, 17 C.F.R. § 240.16b-2 (1949), adopted in 1935, purported to exempt certain underwriting transactions from the scope of § 16(b). The exemption is necessary only on the assumption that a person who acquired 10% of a class of equity security by virtue of an underwriting agreement was otherwise within § 16(b) by virtue of that acquisition.

In *Stella v. Graham-Paige Motors Corp.*,⁴⁴ the Second Circuit held that where the defendant acquired its ten per cent interest in the corporation in one large transaction, sales by the defendant made within six months thereafter were subject to the provisions of section 16(b), any profits from such sales being payable to the corporation.⁴⁵ Judge Hincks dissented on the ground that there is no ambiguity in the statutory language of "shall not be construed to cover any transaction where such beneficial owner was not such both at the time of the purchase and sale"⁴⁶ Judge Hincks based his dissent on two points:

(1) There is no room for "construction" of the statutory language, which plainly and unambiguously means that for a transaction to be covered, the beneficial owner must be such at the time he makes the purchase and the time he makes the sale, not *as a result* of making the purchase.

(2) The basic rationale of the Securities Exchange Act involves the removal of the possibility of profit to one who deals in a corporation's stock on the basis of inside information; a person is conclusively presumed not to have access to inside information until after he has become the owner of at least a ten per cent interest—therefore the purchase by which he becomes a ten per cent beneficial owner does not constitute a part of a prohibited transaction under section 16(b).

There is considerable merit in Judge Hincks' position. To "construe" the statutory wording in the manner adopted by the majority appears to be the grossest type of unwarranted judicial legislation.

⁴⁴ 232 F.2d 299 (2d Cir. 1956).

⁴⁵ The court approved the holding of the trial judge, 104 F. Supp. 957 (S.D.N.Y. 1952), that the defendant became the beneficial owner of more than 10% of the corporation's stock at the very moment when it purchased that stock. The trial judge said, at p. 959: "If the construction urged by defendant is placed upon the exemption provision, it would be possible for a person to purchase a large block of stock, sell it out until his ownership was reduced to less than 10%, and then repeat the process, ad infinitum. A construction such as this would provide a way for the evasion of Section 16(b) by principal stockholders, and render it largely ineffective to prevent some of the financial evils which led to the passage of the legislation by Congress. . . ." The trial judge went on to say, at p. 960, that the exemption provision was intended "to exclude the second sale in a case where 10% is purchased, 5% sold within three months, and the remaining 5% a month later," quoting Seligman, "Problems Under The Securities Exchange Act," 21 Va. L. Rev. 1, 20 (1934). In addition to approving the trial judge's interpretation, the Second Circuit based its decision on its prior holding in *Blau v. Ogsbury* that the exercise of an option which gave the optionee a 10% interest in the corporation constituted a "purchase," so that profits on sales of stock within six months before or after the exercise of the option would be recoverable for the corporation under § 16(b).

⁴⁶ Securities Exchange Act of 1934, *supra* note 2, § 16(b), as quoted in Judge Hincks' dissent, 232 F.2d 299, 303 (1956).

The evil said to result from the adoption of Judge Hincks' view⁴⁷ is hardly removed by the adoption of the majority construction. It is easy enough to acquire a large block of stock in two transactions, rather than one, and thus to a great extent avoid the rule of the *Stella* case.⁴⁸

Although it seems likely that, as almost all section 16(b) litigation arises in New York, the majority opinion will prevail,⁴⁹ the only other court to consider the matter adopted Judge Hincks' reasoning. This decision, *Arkansas-Louisiana Gas Co. v. W. R. Stephens Inv. Co.*,⁵⁰ the only section 16(b) case ever to arise in the district court for Arkansas, is entitled to serious consideration. It is (unlike many of the district court decisions under section 16(b) arising outside New York⁵¹) a well-reasoned opinion in harmony with the general principles laid down in *Smolowe v. Delendo Corp.* and following cases. The other major holding of the Arkansas case is that a broker-dealer firm, the beneficial owner of more than ten per cent of a class of equity security in the named gas company, was liable under section 16(b) for profits made in dealing in shares of the gas company in the course of its regular investment business, even though it made no use of inside information and made no sales out of the block of stock (amounting to over ten percent of the total issued) which it held for investment purposes.

c. *Who is an "Officer"?*

In two recent cases concerning the important and troublesome question of who is an "officer" subject to the rule of section 16(b), the judges of the Southern District of California have rather clearly demonstrated error in the position taken by the far more experienced (in securities litigation) Second Circuit. In 1934, pursuant to its

⁴⁷ The "evil" referred to is that set out in note 45, supra.

⁴⁸ It will be a comparatively rare case in which the acquisition of a block of stock in a corporation having a security listed on a national exchange will be much greater than 10%, and even in such cases, Judge Hincks' version of the rationale of the act is more logical than that of the majority.

⁴⁹ Earlier reference has been made to the SEC's implied adoption of the theory of the majority in the *Stella* case by virtue of the promulgation of Rule X-16B-2, 17 C.F.R. § 240.16b-2 (1949); the majority opinion noted that the SEC had adopted this viewpoint expressly in a general counsel's opinion. 11 Fed. Reg. 10968 (1946). The SEC also filed a brief as amicus curiae in the lower court in *Stella*, 104 F. Supp. 957 (1952), in support of what became the court's interpretation. 232 F.2d 299, 301 (1956).

⁵⁰ 141 F. Supp. 841 (W.D. Ark. 1956).

⁵¹ For examples of "maverick" decisions, see *Consolidated Engineering Corp. v. Nesbit*, 102 F. Supp. 112 (S.D. Cal. 1951), rev'd sub nom. *Pellegrino v. Nesbit*, 203 F.2d 463 (9th Cir. 1953); *Dottenheim v. Murchison*, 127 F. Supp. 790 (N.D. Tex.), rev'd, 227 F.2d 737 (5th Cir. 1955), cert. denied, 351 U.S. 919 (1956).

rule making power under the Securities Exchange Act, the SEC promulgated rule X-3B-2, providing:

The term 'officer' means a president, vice-president, treasurer, secretary, comptroller, and any other person who performs for an issuer, whether incorporated or unincorporated, functions corresponding to those performed by the foregoing officers.⁵²

The SEC later interpreted this regulation as leading to the conclusion that an assistant treasurer, an assistant secretary, and an assistant comptroller are not officers unless their chief is so inactive as to thrust the burden of the office upon them.⁵³ In *Colby v. Klune*,⁵⁴ the Second Circuit expressed doubt as to the validity of the SEC's definition, suggesting instead a subjective test which would include as an officer:

A corporate employee performing important executive duties of such character that he would be likely, in discharging these duties, to obtain confidential information about the company's affairs that would aid him if he engaged in personal market transactions. . . . It is immaterial how his functions are labeled or how defined in the by-laws, or that he does or does not act under the supervision of some other corporate representative.⁵⁵

After the *Colby* decision the SEC proposed, in 1952, to amend the definition of "officer" in Rule X-3B-2 so as to include other corporate employees "performing important executive duties of such character that they would be likely, in discharging their duties, to obtain confidential information about their company's affairs."⁵⁶ This proposed amendment was not adopted, primarily because of its uncertainty of application, and in *Lockheed Aircraft Corp. v. Rathman*,⁵⁷ the court disapproved the holding of *Colby v. Klune*, pointing out that the "other person" provision of rule X-3B-2 "does not relate to an employee who assists one of the enumerated officers or performs any of the functions of his office during his absence, but relates to an officer, regardless of title, the functions of whose office correspond to those performed by one of the enumerated officers."⁵⁸

⁵² 17 C.F.R. § 240.16b-2 (1949).

⁵³ Securities Exchange Act release No. 2687, November 16, 1940.

⁵⁴ 178 F.2d 872 (2d Cir. 1949).

⁵⁵ *Id.* at 873.

⁵⁶ 20 U.S.L. Week 2613 (June 24, 1952); see 106 F. Supp. at 814.

⁵⁷ 106 F. Supp. 810 (S.D. Cal. 1952).

⁵⁸ *Id.* at 813. The Rathman case is additionally interesting in that the corporation concerned had, prior to granting the option to its assistant treasurer to purchase the stock in question, inquired of the SEC whether or not such assistant treasurer was an "officer," and the SEC had ruled that he was not. The court pointed out at p. 814 that the fact situation fell within the purview of the last sentence of § 23(a), providing:

"No provision of this title imposing any liability shall apply to any act done or omitted in good faith in conformity with any rule or regulation of the Commission or the Board of Governors of the Federal Reserve System, notwithstanding that such

In *Lockheed Aircraft Corp. v. Campbell*,⁵⁹ a different judge of the same district court which decided the *Rathman* case refused to adopt either the subjective test of *Colby v. Klune* or the objective test of *Rathman*. The judge thought that *Colby* went too far in stating that it was immaterial to a decision on the question as to how the alleged officer's functions were labeled or whether he acted under the supervision of some other corporate representative. On the other hand the court felt that *Rathman* was too narrow, since:

It is conceivable that in a corporation like Lockheed, with complex activities, two persons might perform the functions of treasurer, secretary, and comptroller, each doing, within a certain sphere of the corporation's far-flung activities, exactly the same things.⁶⁰

The court therefore inquired into the actual responsibilities of the defendant's job, and finding that he had no concern with questions of policy, held him not to be an officer within the meaning of section 16(b). There the matter rests; from the standpoint of certainty and practical administration there is a great deal to be said for the Commission's early interpretation of rule X-3B-2, as approved in *Rathman*. On the other hand, the holding of *Campbell* seems more nearly to effectuate the purposes of the statute. Probably either the *Rathman* or the *Campbell* rule would prove to be workable, while the rule of *Colby v. Klune* would lead to unnecessary confusion.

d. Stocks of Different Classes

One other potentially troublesome question of coverage under section 16(b) should be noted—whether a recovery is permissible by a corporation under section 16(b) where stock of one class is purchased and stock of another class is sold.⁶¹ This question, which conceivably could raise tremendously complex questions of valuation, has fortunately not plagued the courts. Mr. Loss has suggested that:

There are no ready answers, but the test (as to what securities are sufficiently identifiable so as to make the purchase of one and the sale of

rule or regulation may, after such act or omission, be amended or rescinded, or be determined by judicial or other authority to be invalid for any reason."

The court, recognizing the rule against estoppel of corporations, went on to say:

"This Court is not suggesting that plaintiff has in any way estopped itself from enforcing the liability asserted because of its reliance on the S.E.C. Regulations in the administration of its plan. The reliance of plaintiff on the Regulations is alluded to only to emphasize defendant's own reliance on the S.E.C. rule, a reliance which apparently was shared by plaintiff, itself."

It is interesting to speculate on how the court would have resolved this apparent conflict between § 23(a) and the "no estoppel" rule, had it found it necessary to do so.

⁵⁹ 110 F. Supp. 282 (S.D. Cal. 1953).

⁶⁰ *Id.* at 284.

⁶¹ *Cf. Smolowe v. Delendo Corp.*, discussed above.

the other a transaction within Section 16(b)) should presumably be whether the securities may be so assimilated as to afford a means of in-and-out trading profits derivable from use of inside information.⁶²

In *Falco v. Donner Foundation, Inc.*,⁶³ the court, dealing with the arbitrage exemption under section 16(d), indicated that convertible stocks and bonds are of the same class as the security into which they may be converted, saying:

It will readily be seen that for all practical purposes a convertible bond is equivalent to the number of shares of stock into which it is convertible. A right or warrant plus the subscription price is theoretically equivalent to the stock on which the right or warrant has a call.⁶⁴

This seems to bear out Mr. Loss' statement.⁶⁵

II. WHAT ARE "SALES" AND "PURCHASES"

One of the most troublesome problems in section 16(b) interpretation (and one still unresolved, at least insofar as the evolution of a general rule is concerned) is that of determining what are "sales" and "purchases." The statute itself provides that the terms "buy" and "purchase" include any contract to buy, purchase, or "otherwise acquire," and the terms "sale" and "sell" each include any contract to sell "or otherwise dispose of."⁶⁶ Such sketchy language has proved to be of little help in determining whether acquisitions by virtue of reorganizations, mergers, consolidations, and dissolutions constitute "purchases," and the courts have been reluctant to construe the statutory definition of "sales" as including such dispositions as gifts.

The first case directly on the point, *Park & Tilford, Inc. v. Schulte*, involved the exercise by controlling stockholders of the privilege of converting some of their preferred stock into common, and their subsequent sale of the common within six months. The Second Circuit held⁶⁷ that the conversion of the preferred into common followed within six months by a sale of the common is a "purchase and sale" within the meaning of section 16(b). The decision indicated

⁶² Loss, *op. cit.* supra note 3, at 578.

⁶³ 208 F.2d 600 (2d Cir. 1953).

⁶⁴ *Id.* at 603.

⁶⁵ Note Mr. Loss' further statement at p. 263 (1955 Supp.):

"Whatever the answer to the question whether convertible preferred and common may be matched, logically the same answer should apply to the several securities involved in a merger, consolidation, sale of assets, or reclassification after approval and public announcement; for at that point the securities will tend to sell in substantially the same relation to each other as the ratios specified in the merger and so on."

⁶⁶ Securities Exchange Act of 1934, supra note 2, §§ 3(a)(13) and 3(a)(14).

⁶⁷ Unanimously upon this point, although Judge Swan dissented on the method of determining the purchase price, a point discussed later in this paper.

an intent to give the broadest possible construction to the statutory provisions that the definition of "sales" and "purchases" include "any contract to buy, purchase, or otherwise acquire" and "any contract to sell or otherwise dispose of," specifically holding that the language "any contract to purchase, or otherwise acquire" necessarily included completed acquisitions as well as executory contracts.⁶⁸ Like so many other apparently hard and fast rules of construction, this one was soon found to require many modifications.

In *Truncale v. Blumberg*, the defendant was issued valuable stock warrants annually in accordance with the terms of his employment contract. Within six months of receiving some of the warrants, he gave them to various legitimate charities. Plaintiff stockholders claimed, supported by an amicus curiae brief of the Securities Exchange Commission filed at Judge Medina's request, that the gifts to charities were "sales."⁶⁹ In spite of the all-inclusive phraseology of section 3(a)(14),⁷⁰ the court refused to concede that a gift was a "sale," explaining away *Park & Tilford* as follows:

Doubtless it was the intention of the Congress that the terms of Section 16(b) should cover any acquisition or disposal of the securities which might reasonably be considered in the category of a 'purchase' or a 'sale' in connection with which an insider might profit by the use of confidential information to the detriment of the outside stockholders and the corporation.

This is what I think was decided in the leading cases of *Smolowe v. Delendo Corporation* . . . and *Park & Tilford v. Schulte*. . . . I find that these gifts do not constitute 'sales' and that there was no profit.⁷¹

In *Blau v. Hodgkinson*⁷² the court held that the receipt of warrants by a corporate officer under his contract of employment constituted a purchase,⁷³ and further held that receipt of stock in a parent corpo-

⁶⁸ The court said: "Whatever doubt might otherwise exist as to whether a conversion is a 'purchase' is dispelled by the definition of 'purchase' to include 'any contract to buy, purchase, or otherwise acquire.' Section 3(a)(13). Defendants did not own the common stock in question before they exercised their option to convert; they did afterward. Therefore they acquired the stock, within the meaning of the act." 160 F.2d 984, 987 (1947).

⁶⁹ The plaintiff stockholder established the "profit" to be recovered by the corporation as the amount of the economic benefit gained by the defendant through taking a deduction on his tax return for the market value of the warrants at the time of the gift. The SEC brief did not support this position, and the court expressed itself as being offended by the plaintiff's characterization of defendant's gifts to the charities as a "tax dodge."

⁷⁰ "The terms 'sale' and 'sell' each include any contract to sell or otherwise dispose of."

⁷¹ 80 F. Supp. 387, 391-92 (1948). The court said, however, by way of dictum, that the acquisition of the warrants by the defendant at the time of their actual issuance to him did constitute purchases within the meaning of § 16(b).

⁷² 100 F. Supp. 361 (S.D.N.Y. 1951).

⁷³ But restricted the repayment for which the corporate officer was liable after sale of securities acquired on exercise of the option to the difference between the proceeds

ration in exchange for stock in a subsidiary pursuant to a plan of reorganization, constituted a "purchase," where the insider had an option to dissent from the plan and to receive cash instead. The opinion clearly indicated that the exchange would probably not have been considered a "purchase" within the meaning of section 16(b) had the insider been obligated to accept the stock of the parent by virtue of the reorganization.⁷⁴

The broad implications of the *Park & Tilford* case (that all acquisitions are "purchases" and that all dispositions are "sales") were further narrowed by the Second Circuit in *Shaw v. Dreyfus*, where a distinction was drawn between the receipt of warrants by a corporate officer pursuant to his contract of employment (held taxable in *Blau v. Hodgkinson*) and the receipt of warrants issued pro rata to all common stockholders of record. In refusing to hold the latter type of receipt to be a "purchase," the court said:

"Inside" information which the directors may have cannot possibly be used to the detriment of other stockholders in voting to grant rights to all stockholders of record in proportion to their existing holdings. . . . "Purchase" is not an apt word to describe the receipt by a stockholder of shares representing a stock dividend or of warrants representing his pre-emptive right to subscribe for new shares. Nor will the purpose of the Statute be defeated by refusing so unusual a meaning to the word.⁷⁵

The court also affirmed the holding of *Truncala v. Blumberg* that a gift, although obviously a disposition, is not a "sale" within the meaning of section 16(b).⁷⁶

The nice distinctions involved in determining what are and are not "sales" and "purchases" are well illustrated by *Blau v. Mission Corp.*⁷⁷ In 1948, the Mission Corporation, pursuant to a plan to gain control of Tidewater Oil Company, had acquired almost one and one-half million shares of Tidewater's common stock, more than ten per cent of the total. Mission organized a subsidiary and transferred its block of Tidewater stock to the subsidiary in return for the subsidiary's shares, at the ratio of two shares of the subsidiary for one share of Tidewater. Mission continued to purchase Tidewater shares,

of the sale and the lowest market price of such security within the six-month period preceding and the same period succeeding the date of sale, in accordance with rule X-16B-6, 17 C.F.R. § 16b-6 (1949). For a further discussion of this rule, see the section "Administrative Exemptions," *infra*.

⁷⁴ 100 F. Supp. 361, 373 (1948).

⁷⁵ 172 F.2d 140 (1949).

⁷⁶ Judge Clark dissented on both holdings, apparently believing that the broad definitions of "sale" and "purchase" contained in the Securities Exchange Act should be construed to include literally all types of acquisition and disposition.

⁷⁷ 212 F.2d 77 (2d Cir.), cert. denied, 374 U.S. 1016 (1954).

and by 1951 it owned an additional one million shares, which it then transferred to the subsidiary at the same two-for-one ratio. Between the time of the two transfers by Mission Corporation to the subsidiary of Tidewater, Mission had distributed some of the subsidiary's shares as dividends to Mission's stockholders, reducing Mission's ownership of the subsidiary to sixty per cent. The subsidiary's stock was traded on the New York Stock Exchange, and though its intrinsic value was absolutely tied to the underlying Tidewater stock constituting substantially all of its assets, its stock sold at a discount.

The Second Circuit held that the first exchange of Tidewater stock for stock of the subsidiary was not a sale within section 16(b), but that the second exchange was, distinguishing the two by the following reasoning: The first transaction was a mere transfer between corporate pockets. "To hold otherwise would be to place entirely undue stress on the corporate fiction reaching harsh and wooden results quite unnecessary to achieve the purposes of the act."⁷⁸ At the time of the second exchange Mission still owned sixty per cent of the subsidiary's stock and thus had obviously not relinquished actual control of the subsidiary's block of Tidewater stock. Nor did Mission alter its beneficial interest in the Tidewater stock, since the second exchange with the subsidiary was at the same two-for-one ratio as the first. It is conceded that the second exchange did not give rise to a gain for tax purposes,⁷⁹ and the SEC had, after due consideration and full disclosure, approved both exchanges by granting exemptions from the provisions of the Investment Company Act of 1940 prohibiting inter-affiliate transactions. Nevertheless, since the second exchange did not constitute merely a transfer between corporate pockets (Mission owning only sixty per cent of the subsidiary's stock) and since the subsidiary's stock received by Mission on the second exchange was readily salable and of independent market value, the second exchange constituted a "sale" by Mission of the Tidewater stock, profits received by Mission being payable to Tidewater under section 16(b).

The court re-enforced its reasoning by pointing out that:

. . . [I]f Mission were to receive stock in an exchange such as this, and thereafter sell it within six months, we have no doubt that the ex-

⁷⁸ *Id.* at 80.

⁷⁹ Int. Rev. Code of 1939, § 112(b)(5) (now Int. Rev. Code of 1954, § 351), provides for the non-recognition of gain or loss where property is transferred to a corporation solely in exchange for stock, and immediately after the exchange the transferor is in control of the corporation. The court held that Mission was clearly an "insider" since, by virtue of its absolute control of the subsidiary corporation, it was indirectly the owner of all the Tidewater stock held by the subsidiary. Section 16(a), Securities

change would be a 'purchase' within Section 16(b) [under *Park & Tilford, Inc. v. Schulte*].⁸⁰

The defendant of course argued that there could be no "sale" since its commitment in Tidewater stock had in no way been reduced by the exchange. The court attempted to meet this by saying:

. . . [R]educed or not, the ownership has been one step removed and the intervening [subsidiary's] stock is independently valuable. It is not beyond conceit that an insider would possess information which when publicly released would depress Tidewater prices while enhancing those of [the subsidiary]. . . .⁸¹

Two weeks after handing down its decision in *Blau v. Mission Corp.*, the Second Circuit heard argument in *Roberts v. Eaton*.⁸² The defendants were a family group owning 45.9 per cent of the outstanding common stock of Old Town Corporation. Deciding to divest themselves of their interest in the corporation, they proposed, and obtained stockholder approval of, a re-classification of the outstanding \$5 par value common stock into an equal number of shares of \$1 par value common and a similar number of shares of cumulative preferred stock. Shortly after the stockholders' meeting authorizing the re-classification of the common and the issue of the new cumulative preferred, the defendants simultaneously sold their common stock to an individual and their preferred stock to two life insurance companies and an investment company. Plaintiff stockholders contended that the defendants' receipt of the re-classified stock was a "purchase" within section 16(b), and that their profits on the sale of the new common and cumulative preferred were recoverable for the corporation.

For the first time the Second Circuit attempted to decide this issue by matching the facts against all prior decisions dealing with "sales" and "purchases," declining the "enunciation of a black-letter rubric," but concluding that the receipt by the defendants of the reclassified common and the new cumulative preferred did not constitute a "purchase" within section 16(b). The court relied on the following factors, said to distinguish the instant case from previous cases in which "sales" and "purchases" had been found: (1) The reclassification of the common and issue of the new cumulative preferred af-

Exchange Act of 1934, defines an insider as "every person who is directly or indirectly the beneficial owner of more than ten per centum of any class of any equity security. . . ."

⁸⁰ 212 F.2d 77, 81 (1954).

⁸¹ *Id.* at 81. The last sentence of the quotation may be true, but it is difficult to conceive of what such information would consist.

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

fects all stockholders equally. (2) The stocks received as a result of the reclassification were without pre-existing market value. (3) After the reclassification, the defendants continued their interest in the corporation, with no change in their proportionate interests.

Conceding that the enumerated distinctions had each been strongly challenged, the court said:

As a matter of fact it seems quite possible that no one of the factors we have enumerated, standing alone, would be sufficient for that result [to immunize the transaction from application of Section 16(b)] but in cumulative effect we think that they are. The reclassification at bar could not possibly lend itself to the speculation encompassed by Section 16(b). This being so, it was not a "purchase" and the decision below was correct.⁸³

The court was wise in not renewing the attempt of the old *Park & Tilford* case to set down a firm rule to cover all transactions. Considerably more litigation will be necessary before the effects of section 16(b) on given types of corporate organizations, reorganizations, and dissolutions can be predicted without chance of error.⁸⁴

The latest reported section 16(b) decision, *Blau v. Albert*,⁸⁵ further illustrates the complex problems involved in determining what constitute "sales" and "purchases." Defendant, the beneficial owner of more than ten per cent of Bellanca Corporation's equity securities, purchased over 1,000,000 shares of Bellanca stock and within six months allegedly sold 50,500 of such shares at a profit. Defendant, on motion for summary judgment, contended that the disposition of the 50,500 shares was not a "sale," since (1) 23,500 shares were transferred to individuals as compensation for services rendered in connection with the purchase of the million-plus share block, and there was, therefore, either no profit on the disposition of

⁸³ Id. at 86. Texas lawyers may find this technique and reasoning interestingly similar to Judge Brewster's in the well-known case of *Smerke v. Office Equipment Co.*, 138 Tex. 236, 158 S.W.2d 302 (1941), holding that while no one of several instances of improper jury argument might require reversal of a judgment in favor of the party so arguing, all the incidents complained of, taken together, required such reversal.

There is also an analogy to the well-known principle of federal income tax law that a series of transactions which taken separately will produce one result, may, when considered as integral parts of one over-all plan, produce an opposite result. For example, see *Helvering v. Gregory*, 69 F.2d 809 (2d Cir. 1934), aff'd, 293 U.S. 465 (1935). In the latter case, however, the doctrine always works for the government, and never in favor of an individual, as in the *Eaton* case.

⁸⁴ In both *Roberts v. Eaton* and *Blau v. Mission Corp.* the SEC declined the court's request to file an amicus curiae brief. The court announced its regret, but in view of the delicate nature of the problem and the tendency of administrative agencies to argue in favor of maximum coverage, it is hard to share the court's sorrow, particularly since the Second Circuit has itself of necessity developed competence in the field. Probably the majority of attorneys and laymen prefer interpretation by courts rather than administrative agencies wherever practicable.

⁸⁵ CCH Fed. Sec. L. Rep. para. 90836 (S.D.N.Y. Dec. 16, 1957).

the shares, or there was no sale of the shares since the defendant had initially acquired them merely on behalf of the persons entitled to such compensation; and (2) the remaining 27,000 shares were disposed of by gift and not by sale. As to the 23,500 shares delivered as commissions, the court held that such deliveries would constitute "sales," whether they were treated as being in payment for a pre-existing debt (*i.e.*, a debt for commissions) or as a brokerage transaction in which the defendant originally acquired such stock merely on behalf of the ultimate recipients.

As to the 27,000 shares claimed to have been disposed of by gift, the court noted that the defendant had filed reports with the SEC under section 16(a) in which the transfer of these shares was indicated as "sales made privately for investment" and that there was enough question as to the alleged charitable donation being a subterfuge that the issue must be determined on a trial.

III. THE NATURE AND MEASURE OF RECOVERABLE "PROFITS"

As noted above, *Smolowe v. Delendo Corp.*, the first case to arise under section 16(b), established the principle that recoverable "profits" are measured by matching the insider's lowest-cost purchases against his highest-prices sales during any six month period.⁸⁶ The court rejected the basic income tax rule of identification of stock certificates, both because it would allow the large stockholder to speculate with impunity merely by reason of having a reserve of stock and carefully choosing his stock certificates for delivery so as never to make a sale of a certificate purchased less than six months before, and for the further reason that the "identification" rule would be almost impossible to apply in cases where the sale part of the transaction preceded the purchase. The court similarly rejected the "first-in, first-out" rule, and, since the statute itself provides for the recovery of "any" profit realized, precluded any setting off of losses against gains. The court said:

The only rule whereby all possible profits can be surely recovered is that of lowest price in, highest price out — within six months — as applied by the District Court. We affirm it here, defendants having failed to suggest another more reasonable rule.⁸⁷

This holding was reaffirmed in *Gratz v. Claughton* and has not been questioned since. In *Park & Tilford, Inc. v. Schulte*, there was presented an unusual situation involving apparent manipulation by the

⁸⁶ See note 27 *supra* and accompanying text.

⁸⁷ 136 F.2d 231, 239 (1943).

insiders (who controlled the corporation) producing an unrealistic discrepancy between the value of preferred stock and the value of the common stock into which the preferred was convertible. The court held that the cost basis to the insider (of stock later sold at a profit) is determined by the value of the assets delivered by him in the original exchange for the stock, and not by the value of the stock received in the exchange and later sold.

Where options or warrants are acquired incident to a contract of employment and not for a cash consideration, and are subsequently sold, the "profit" is measured by the difference between the sales price and the value of the option at the date of its accrual.⁸⁸ And the value of the option is established merely by taking the difference between the exercise price and the market value of the stock underlying the option.⁸⁹ Where the option is exercised and the stock later sold, the date of the "purchase" is the date of exercise and not the date upon which payment is finally made pursuant to such exercise.⁹⁰ The cost basis is nevertheless the option price plus the value of the option, not on the date of exercise, or the date of payment pursuant to the exercise, but on the date of accrual of the option right.⁹¹ (The entirely different treatment of transactions on stock acquired pursuant to the exercise of options under a bonus profit-sharing, retirement, stock option, thrift, savings, or similar plan meeting certain specified requirements is discussed in the section on "Administrative Exemptions," *infra*.)

The *Park & Tilford* rule that the cost basis for determining profits on securities acquired and later sold within six months is the value of what the insider gave in exchange for the stock and not the market

⁸⁸ *Steinberg v. Sharpe*, 95 F. Supp. 32 (S.D.N.Y. 1950), *aff'd per curiam*, 190 F.2d 82 (2d Cir. 1951); *Truncale v. Blumberg*, 88 F. Supp. 677 (S.D.N.Y.), *aff'd per curiam sub nom. Truncale v. Scully*, 182 F.2d 1021 (2d Cir. 1950).

⁸⁹ *Blau v. Hodgkinson*, 100 F. Supp. 361 (S.D.N.Y. 1951).

⁹⁰ *Blau v. Ogsbury*, 210 F.2d (2d Cir. 1953). In 1941, as part of his agreement of employment, the corporate president was given an unassignable option to purchase company stock at a fixed price per share. In 1945, the president gave notice of his election to purchase the shares under the option, which action clearly obligated him to pay the purchase price. However, he postponed payment until December 8, 1948, and shortly thereafter received his stock. Within six months prior to the December 8, 1948 payment, the president had sold 600 shares of identical stock at a price greatly in excess of the option price on the stock purchased under the employment agreement. Against plaintiff's contention that the "purchase" occurred when the option stock was paid for, the court held that the "purchase" occurred, not at the time of payment, but on the date over three years earlier on which the defendant became irrevocably liable for the purchase price. Since there were no other transactions involved, § 16(b) was held not applicable.

⁹¹ *Blau v. Hodgkinson*, 100 F. Supp. 361 (S.D.N.Y. 1951); *Steinberg v. Sharpe*, 95 F. Supp. 32 (S.D.N.Y. 1950). In these cases the amount of recovery is often mitigated by rule X-16B-6, discussed in text *infra*.

value at the time of the purchase of the stock purchased has been recently applied in *Blau v. Lamb*⁹² and in *Stella v. Graham-Paige Motors Corp.*, the latter case involving a complex fact situation in which the insider had exchanged a miscellaneous collection of tangible and intangible assets for stock and other items.⁹³

In the *Park & Tilford* case the defendant was held liable for repayment to his corporation of larger profits than he otherwise would have made, by application of the rule that the cost basis for determining the profits realized is fixed by the value of the assets which the insider transfers for his corporation's stock in the purchase part of the transaction, rather than the value of the stock received in the purchase. In *Blau v. Mission Corp.*, discussed above, the "purchase" part of the transaction involved cash, but the "sale" part involved the exchange by the insider of his corporation's stock for stock in another company, where the stock "sold" had a market value higher than that of the stock received. The plaintiff attempted to apply the *Park & Tilford* rule to compute defendant's liability, but the court refused to do so, holding that, whereas the *purchase* price must be determined by looking to the consideration parted with, the *sale* price is the consideration received, not the different value (higher or lower) of the stock sold.⁹⁴

The recent case of *Blau v. Albert* involved a purchase of a large amount of stock by an insider and a subsequent transfer by him of a portion of the stock in payment for services rendered in connection with his acquisitions. The precise fact situation does not appear, since the reported decision is on a motion for summary judgement, but the court stated its belief that, it appearing that the insider and the transferees contemplated that compensation for the value of the services rendered to the insider would be partially defrayed by an anticipated rise in the value of the shares transferred, the defendant should be held accountable for profits to the same extent as if he had sold the stock on the open market for an amount representing the increased market value. While it is not entirely clear, the court apparently is merely saying that the value received on the "sale" is determined by the value of the stock transferred at the time of the transfer — a result in line with prior authority.

⁹² 20 F.R.D. 411 (S.D.N.Y. 1957).

⁹³ In the assets-for-stock-and-other-assets exchange between Graham-Paige Motors and Kaiser-Frazer, both parties were forced by economic realities to enter into the transaction, and Kaiser-Frazer was the only possible purchaser for the Graham-Paige assets. The court refused to apply the usual "fair market value" test since neither Graham-Paige nor Kaiser-Frazer could be classified as a "willing buyer" or "willing seller."

⁹⁴ 212 F.2d 77, 81 (1954).

Although the courts uniformly follow the *Smolowe* dictum 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,"⁹⁵ it has become well-established that the insider is liable for payment of "net" profits only, after deduction of at least commissions and transfer taxes incident to the transactions.⁹⁶ *Blau v. Mission Corp.*, dealing with the calculation of profits following private transactions, makes it clear that only expenses actually incurred may be deducted, the court saying:

. . . [E]xpenses are those actually incurred, and not mere possibilities such as might have been incurred had equivalent stock been sold in the market. . . .⁹⁷

The *Arkansas-Louisiana Gas Co.* case probably went much too far in allowing set-off expenses, although the court can hardly be blamed for a sympathetic attitude. The defendant investment company owned, for investment purposes, a large block of Arkansas-Louisiana Gas Company stock. It did not dispose of any of its investment shares, but over a period of time, in response to many requests from customers and citizens of its community, it devoted a great deal of time to trading in the gas company's shares in the course of its regular business as an investment dealer and broker. The court found that the investment company's transactions in gas company stock consumed at least one-fourth of the time of defendant's employees during the period and allowed, as set-off expenses against the gas company's recovery, not only the direct expenses of transfer taxes, insurance and bank charges, but also one-fourth of defendant's general overhead, office rent, salaries, and automobile expenses.⁹⁸ It seems doubtful that the liberality of the Arkansas court will be matched by New York courts when the question arises.

In the *Smolowe* case no mention was made of the possible recovery of interest by the corporation from the insider since the date of the insider's profit, and apparently none was allowed. However, the Sec-

⁹⁵ 136 F.2d 231, 239 (1943).

⁹⁶ *Blau v. Mission Corp.*, 212 F.2d 77 (2d Cir.), cert. denied, 374 U.S. 1016 (1954); *Arkansas-Louisiana Gas. Co. v. W. R. Stephens Inv. Co.*, 141 F. Supp. 841 (W.D. Ark. 1956); *Falco v. Donner Foundation, Inc.*, unreported S.D.N.Y. 1953, rev'd on other grounds, 208 F.2d 600 (2d Cir. 1953).

⁹⁷ On motion for rehearing, 212 F.2d 77, 82 (1954).

⁹⁸ The court, however, disallowed claimed offsets for salesmen's salaries, travel, and entertainment expenses, since no sales campaign was made to sell the stock in question.

ond Circuit, in *Blau v. Mission Corp.*, in issuing directions to the lower court as to proceedings on remand, said:

[A]ny award, if made, should bear interest from the time of sale.⁹⁹

Similar directions on remand were given by the Second Circuit in *Stella v. Grabam-Paige Motors Corp.* In *Magida v. Continental Can Co.*, the same court, although upholding the trial court's award of interest from the date of realization of the profit, pointed out that such allowance of interest is not mandatory. This qualification is somewhat surprising, since certainly the use of the money by the insider from the time of realization of the profit until he is forced to give it up is of benefit to him, and the allowance of interest would seem to be required to comply with the *Smolowe* "squeeze out all the profits" doctrine.¹⁰⁰

In *Falco v. Donner Foundation, Inc.*, where the insider sold securities having dividend rights and simultaneously purchased an equal number of shares of the same securities without dividend rights, the trial court held that the sale and purchase fell within section 16(b) but, adopting the position taken by the SEC in its amicus curiae memorandum, deducted from the recoverable "profits" the amount of dividends which the defendant would have received if it had kept its original stock, leaving defendant with only a nominal liability. While this decision was reversed on appeal, on the grounds that the transaction was entirely exempt as a bona fide arbitrage, the allowance of a set-off for the amount of dividends which the insider would have received during the interval between the sale and purchase is only fair. In the converse case of a purchase followed by a sale, the dividends received by the insider in the interim should be added to the recoverable profits.¹⁰¹

Prior to 1952 the SEC had permitted a partner to report, under section 16(a), either all partnership transactions in stock of a company of which the partner was an insider or only his partnership share, taking the position that section 16(b) would apply only to the insider partner's share of short-swing profits made by the partnership. But in *Rattner v. Lehman*¹⁰² the Second Circuit, although imposing liability only for the insider partner's share of partnership profits from dealing in shares of a corporation of which the partner was a director, indicated that under certain circumstances the insider

⁹⁹ 212 F.2d 77, 82 (1954) (on motion for rehearing).

¹⁰⁰ The Arkansas-Louisiana Gas Co. case similarly made no mention of interest and apparently allowed none.

¹⁰¹ See Loss, Securities Regulation 258 (1955 Supp.).

¹⁰² 193 F.2d 564 (2d Cir. 1952).

partner might be liable for his partnership's entire profit. Subsequent cases have without discussion imposed liability on the insider partner in similar situations only to the extent of his partnership interest,¹⁰³ but in these cases there was no question of actual use of inside information, and the question is left open as to whether a corporate insider whose partnership profits from the use of such information may be liable for the full amount of the partnership profits.¹⁰⁴

IV. EXEMPTIONS

a. *Statutory Exemptions*

By its terms section 16 does not apply to insider's short-swing profits from the purchase and sale, or sale and purchase, of:

- (1) An exempted security;¹⁰⁵
- (2) Securities acquired by the insider in good faith in connection with a debt previously contracted;
- (3) Transactions where the beneficial owner (but not an officer or director) was not such beneficial owner both at the time of the purchase and sale, or the sale and purchase, of the security involved;
- (4) "Any transaction or transactions which the Commission by rules and regulations may exempt as not comprehended within the purpose of this subsection;"¹⁰⁶ and
- (5) Foreign or domestic arbitrage transactions, unless made in contravention of such rules and regulations as the Commission may adopt.

There has been comparatively little litigation dealing with the "statutory exemptions," as differentiated from the administrative exemptions pursuant to the Commission's rules. The limited scope of the exemption for a security "acquired in good faith in connection with a debt previously contracted" was indicated in *Smolowe v.*

¹⁰³ *Arkansas-Louisiana Gas Co. v. W. R. Stephens Inv. Co.*, 141 F. Supp. 841 (W.D. Ark. 1956); *Marks v. Commissioner*, 27 T.C. 464 (1956).

¹⁰⁴ See Cook and Feldman, *supra* note 21, at 402-05, 628-29.

¹⁰⁵ Section 3(a)(12) of the Securities Exchange Act of 1934 defines "exempted securities" to include securities of or guaranteed by the United States, a state, or any political subdivision thereof, or any agency or instrumentality of any of them; securities of corporations in which the United States has an interest, if designated for exemption by the Secretary of the Treasury; and "such other securities . . . as the Commission may, by such rules and regulations as it deems necessary or appropriate . . . exempt from the operation of any one or more provisions of this title. . . ." Since § 16(b) by its terms applies only to "equity securities," neither United States nor other political subdivision obligations are concerned in § 16(b) enforcement, and § 3(a)(12) is therefore important to the law of insiders' short-swing liability only because of the quoted portion, allowing the Commission to make exemptions.

¹⁰⁶ Since the power of the Commission to adopt rules under § 3 has been broadly construed, nearly all of the exemptive rules adopted by the Commission under the authority of § 16 also refer to § 3(a)(12). Loss, *Securities Regulation 482* (1951). Also see Cook and Feldman, *supra* note 21, at 389.

Delendo Corp., where one of the defendants paid a debt owing to another in stock of a corporation in which they were both insiders. The exemption of subsection (2) above was held to cover the stock in the hands of the person who received it in payment of the other's debt, but not to cover the transfer insofar as the person paying the debt by means of such transfer was concerned. The court said:

The language of the exemption, however, does not naturally cover this situation, and there is no reason in policy why it should. It would mean that profits could be washed out by the simple expedient of borrowing money to be repaid in stock.¹⁰⁷

In its next case under section 16 (b), *Park & Tilford, Inc. v. Schulte*, the Second Circuit refused to apply the "previously-contracted debt" exemption to the acquisition of common stock on a voluntary surrender of convertible preferred, saying:

Ownership of preferred or common stock creates an equity interest, and not a creditor's interest, under these circumstances.¹⁰⁸

And in *Truncale v. Blumberg*, the court rejected the contention that acquisition of stock by virtue of the exercise of an option or warrant given in connection with an employment contract constituted an acquisition "in connection with a debt previously contracted."¹⁰⁹

Of course, the statute in effect exempts, through non-coverage, transactions where the purchase and sale are more than six months apart, and exempts, through its limitations provision, transactions where suit is not brought within two years of realization of the profit. These "exemptions" are dealt with under the sections on "Coverage," *supra*, and "Enforcement," *infra*.

b. *Administrative Exemptions*

Although section 16 of the Securities Exchange Act is phrased in terms of absolute liability, it was designed to perform the definite, limited function of curbing profits obtained by the misuse of information for personal benefit by persons and corporations in the position of "trustees" for all the stockholders, and to curb only short-swing profits at that. The Securities Exchange Commission was, therefore, given the power to act by rules of general applicability to exempt from the interdictions of the statute certain transactions which were not subject to the evils intended to be cured.¹¹⁰

¹⁰⁷ 136 F.2d 231, 239 (1943); accord, *Blau v. Albert*, CCH Fed. Sec. L. Rep. para. 90836 (S.D.N.Y. Dec. 16, 1957).

¹⁰⁸ 160 F.2d 984, 987 (1947).

¹⁰⁹ 80 F. Supp. 387, 392 (1948).

¹¹⁰ See Cook and Feldman, *supra* note 21, at 633.

Rule X-16A-4¹¹¹ exempts securities held by executors, administrators, guardians, receivers, trustees in bankruptcy, and other persons "duly authorized by law to administer the estate or assets of other persons" for the twelve-month period following the appointment or qualification of such holder. The rule as first adopted exempted securities held in the estate of a deceased person for a period of two years. Under the old wording, the contention was made that shares of stock acquired from an estate which had held them two years were exempt securities in the hands of all subsequent holders.¹¹² The rule was therefore amended in 1952 to make clear that the securities themselves are not exempt, but merely transactions by the enumerated class of administrators during the twelve months following their qualification.

Rule X-16A-5 exempts securities purchased or sold by an odd-lot dealer to the extent reasonably necessary to enable him to carry on his regular odd-lot brokerage business. Rule X-16A-9 exempts certain acquisitions of securities where there is no disposition by the acquirer, otherwise than by way of gift, of securities of the same class within six months, and the person acquiring such securities does not otherwise deal in securities of the same class having a market value in excess of \$3,000.00 during any six month period in which the acquisition occurs; it also excludes acquisitions and dispositions of securities by way of gift where the total amount of gifts does not exceed \$3,000.00 for any six month period.

Rule X-16B-1 exempts transactions by registered investment companies which have been exempted by the SEC from section 17(a) of the Investment Company Act, presumably on the ground that the commission would satisfy itself that there was no question of abuse of inside information before granting the exemption under the Investment Company Act. Rule X-16B-4 is a similar provision with reference to approved transactions under the Public Utility Holding Company Act of 1935.

Rule X-16B-2 exempts underwriting transactions provided that at least one person or firm who is not an insider is a participant in the underwriting on equally favorable terms and to an equal extent with the underwriting insider.

Rule X-16B-5 affords relief in the specialized situation where officers and directors of a corporation hold shares in an investment

¹¹¹ 17 C.F.R. § 240.16a-4 (1949). In this and in other citations of SEC rules under the Securities Exchange Act of 1934, the rule number corresponds with the number to the right of the decimal point in 17 C.F.R. §§ 240.0-1 to 240.24b-3 (1949).

¹¹² *Magida v. Continental Can Co.*, CCH Fed. Sec. L. Rep. paras. 90515, 90520, and 90521 (S.D.N.Y. 1951, 1952).

company the sole assets of which consist of stock in the employer corporation. The rule provides that a redemption of the shares of the investment company does not constitute a purchase so as to make profits on the sale of the employer company's stock within six months of the redemption recoverable by the employer company under section 16(b).¹¹³

Rule X-16B-7 exempts transactions in connection with mergers or consolidations which do not result in any significant change (less than fifteen per cent) in the character or structure of the company.

Section 16(d) of the Securities Exchange Act exempts arbitrage transactions except insofar as the Commission may limit the exemption. The Commission has promulgated rule X-16D-1, requiring arbitrage profits realized by officers and directors (but not by beneficial owners as such) to be turned over to the issuer. The scope of the statutory exemption and of rule X-16D-1 were considered in *Falco v. Donner Foundation, Inc.* The Foundation held more than ten per cent of Pittsburgh Steel Company's Class A Preferred Stock. On January 8, 1951, Pittsburgh declared a \$25 dividend on this stock to partially cover accumulated arrearages. On the record date the Foundation sold 2,000 shares bearing the right to receive the dividend and simultaneously purchased 2,000 shares without the right. The next month the procedure was repeated when another arrearage dividend was declared.¹¹⁴ The court held that the transactions in question were exempt under section 16(d) and under rule X-16D-1.¹¹⁵ A bona fide arbitrage transaction was found, with (1) fixed relative values of convertible securities, with fluctuating relative prices; (2) a continuity of the arbitrageur's position in the affected subject matter, remaining constant throughout the offsetting transactions; and (3) a simultaneous purchase and sale. The court pointed out that:

The very factors which identify arbitrage effectively insulate it from any wrongful use of inside knowledge. . . . Indeed arbitrage is so clearly divorced from the abuses which Section 16(b) seeks to prevent, that an implied exception could be urged with some force even absent the express provisions of Section 16(d).¹¹⁶

¹¹³ See Cook and Feldman, *supra* note 21, at 636.

¹¹⁴ By this procedure the Foundation in effect received the arrearage dividends in the form of capital rather than income. This apparently did not benefit the Foundation under the income tax laws, since it seems to have been tax-exempt, but it did allow the Foundation to facilitate the completion of certain charitable donations from its principal to which it was committed.

¹¹⁵ The lower court had held that the transactions were not exempt, but, giving the Foundation credit for the amount of dividends which it would have received had it kept its original stock, reached a result imposing a negligible liability.

¹¹⁶ 208 F.2d 600, 604 (1953).

The court refused to import into the statute any requirement of an intent to profit by a price spread.

The *Falco* case leaves unanswered two questions: how nearly simultaneous the offsetting purchase and sale must be to constitute a bona fide arbitrage, and whether incidental profits obtained by virtue of fluctuations of the market are exempt under the statute and rule. It does indicate that absolutely simultaneous purchases and sales are not required.¹¹⁷ Before suit the Foundation had paid over to Pittsburgh its incidental profits received by virtue of fluctuations of the market in the amount of \$14,258.59. The court did not pass upon the propriety of this payment, but in the usual case the receipt of what were to the Foundation in this instance "incidental profits" is the very purpose of engaging in the arbitrage, and the *Falco* case appears to constitute authority for their exemption.

Two exemptive rules of the Commission have run into trouble in the Second Circuit, the latest under circumstances which seriously threaten the right of the Commission to make any exemptions whatsoever, in spite of the specific statutory authority to do so; in any event, it is now exceedingly dangerous for anyone to rely upon an exemptive rule in spite of the provisions of section 23 (a).¹¹⁸

The first to come under attack was rule X-16B-6, promulgated by the Commission in 1950, exempting that portion of the profits realized from the purchase and sale, or sale and purchase, of an equity security acquired pursuant to the exercise of an option or warrant, attributable to increment in value occurring more than six months before or after the date of sale, provided that the option or similar right was acquired more than six months before its exercise or pursuant to the terms of an employment contract entered into more than six months before its exercise. The rule was announced as effective retroactively.

Blau v. Hodgkinson upheld both the Commission's right to promulgate rule X-16B-6 and its right to give the rule retroactive ef-

¹¹⁷ Id. at 603, n. 2. Compare Cook and Feldman, *supra* note 21, at 391: "A purchase at the close of the New York market and a sale two hours later in San Francisco would not meet the requirement of bona fides."

¹¹⁸ Section 23 (a) of the Securities Exchange Act reads as follows:

"The Commission and the Board of Governors of the Federal Reserve System shall each have power to make such rules and regulations as may be necessary for the execution of the functions vested in them by this title, and may for such purpose classify issuers, securities, exchanges, and other persons or matters within their respective jurisdictions. No provision of this title imposing any liability shall apply to any act done or omitted in good faith in conformity with any rule or regulation of the Commission or the Board of Governors of the Federal Reserve System, notwithstanding that such rule or regulation may, after such act or omission, be amended or rescinded or be determined by judicial or other authority to be invalid for any reason."

fect. But in *Rattner v. Lebman*, the Second Circuit, by way of dictum, stated that rule X-16B-6 (providing for an exemption of a portion of profits realized from short-swing trading) was beyond the Commission's authority, saying:

The Commission may exempt 'transactions'; but it cannot reduce the liability imposed by section 16(b).¹¹⁹

This dictum appears improper. Such an interpretation would force the Commission, whatever the circumstances of a requested exemption, to choose between exempting a transaction entirely or denying the exemption entirely. Having to make such a choice would force the Commission to perpetrate injustices upon individuals, or to extend exemptions beyond the statutory policy in order to avoid such injustices. Rule X-16B-6 remains in the books.

Rule X-16B-3 exempts the acquisition (but not the sale) of non-transferable options or of shares of stock, including stock acquired pursuant to such options, by a director or officer (presumably, whether or not also a ten per cent owner), where such stock or option was acquired pursuant to a bonus, profit-sharing, retirement, stock option, thrift, savings, or similar plan; provided that such plan must have been specifically approved by at least a majority of the stockholders, and must effectively limit the aggregate amount of funds or securities which may be allocated thereunder. As originally passed as a rule of general applicability,¹²⁰ the rule exempted only securities acquired "pursuant to a bonus, profit-sharing or other similar plan" meeting the conditions set forth. It did not apply to exempt stock options or stock acquired pursuant to such options.

As a result of congressional enactment in 1950 of what is now section 421, Internal Revenue Code of 1954, providing favorable tax treatment for restricted stock options, the Commission amended and broadened rule X-16B-3, with effective date of November 1, 1952, to include restricted stock option plans.¹²¹ But, apparently trying to keep the rule as general as possible, the Commission's amendment did not specifically refer to restricted stock options, and it was therefore necessary to issue a large number of rulings on individual plans. On May 21, 1956, the Commission adopted an amendment specifically including stock option plans, clarifying the previous ambiguity.¹²²

¹¹⁹ 193 F.2d 564, 566 (1952).

¹²⁰ Rule X-16B-3 was first promulgated in 1935, but by its terms applied only to options granted prior to June 7, 1934.

¹²¹ 17 Fed. Reg. 10388 (1952). For a discussion of the purposes of the 1952 amendment, see *Greene v. Dietz*, 143 F. Supp. 464 (S.D.N.Y. 1956).

¹²² Securities Exchange Act Release, 21 Fed. Reg. 3647 (1956).

Rule X-16B-3 came under judicial scrutiny in *Greene v. Dietz*.¹²³ The defendant insiders held, pursuant to a restricted stock option plan, options to acquire company stock at a fixed price. More than six months after the option accrued, they exercised the options, and within six months thereafter sold other shares of the same stock at a price in excess of the amounts paid by them for their option stock. The defendants had made no purchases of company stock within six months before or after the sales complained of, except to the extent that exercising their previously-granted options should be considered a purchase. The court held that these transactions did not come within the scope of section 16(b), since the Commission's 1952 amendment to rule X-16B-3 was a valid exercise of discretion and therefore effectively exempted the transactions under consideration. In reaching this result, the court relied upon (1) the Commission's administrative interpretation of the rule,¹²⁴ and (2) the reliance by the parties concerned on a specific ruling by the SEC that their acquisitions under the stock option plan would be exempt from section 16(b).

The Second Circuit affirmed,¹²⁵ but only on the ground that the record clearly showed that the defendants had in good faith relied on rule X-16B-3 as exempting their transactions and were thus entitled to the protection of section 23(a).¹²⁶

While not necessary to the decision, the majority took the occasion of denying the power of the Commission to promulgate rule X-16B-3 at all, "inasmuch as the rule's broad language may permit acts by insiders sought to be prevented by the Securities Exchange Act." Judge Lumbard strongly dissented on the grounds that (1) the SEC's conclusion that there was little, if any, danger that ex-

¹²³ 143 F. Supp. 464 (S.D.N.Y. 1956), aff'd, 247 F.2d 689 (2d Cir. 1957).

¹²⁴ The rule as then phrased did not specifically refer to stock acquired under stock option plans, but the Commission consistently interpreted it so to apply. As noted in the text, the 1956 amendment specifically included stock acquired under such plans. Note the suggestion in *Blau v. Hodgkinson*, 100 F. Supp. 361, 373 (1951), that the "crushing liabilities" imposed in the judgment affirmed in *Gratz v. Cloughton* may have led to the adoption of rule X-16B-3 and to the Commission's giving it a broad interpretation and retroactive effect.

¹²⁵ 247 F.2d 689 (2d Cir. 1957).

¹²⁶ Section 23(a) is quoted in full in note 118, supra. Even in this holding, the court took pains to point out that the defendants would not have been excused from the coverage of the short-swing trading provisions if they had merely relied on the Commission's interpretative opinion which had been obtained by their company with reference to the particular stock which defendants acquired under the stock option plan. The court said, *id.* at 695:

"We emphasize that the defendants' exculpatory reliance was on the rule itself, not merely on the interpretative opinion embodied in the letter from the Assistant Director of the S.E.C. That letter was only one link in a chain of circumstances evidencing the defendants' good faith reliance on a valid construction of Rule X-16B-3."

empting acquisitions of stock under certain restricted plans would violate the broad congressional purpose of preventing unfair use of competition was entitled to support, "unless and until there is a clear showing that the Commission has opened a door which Congress meant to keep shut," and (2) at the very least the Commission's expert judgment is entitled to the benefit of any doubt on matters which Congress confided to the Commission's regulation. The majority opinion, in answer to the points raised by the dissent, refused to regard the promulgation of rule X-16B-3 as a matter solely within the expertise of the SEC, stating:

Rather, the question is one of interpreting the Securities Exchange Act in order to ascertain whether the Rule was a proper exercise of the authority delegated to the Commission under that Act.¹²⁷

Neither party to the action sought a rehearing, but the SEC filed an application for permission to file an *amicus curiae* petition for rehearing, stating that it was then engaged in a re-evaluation of X-16B-3. Permission to file was granted, but upon consideration of the SEC's brief, the majority refused the petition for rehearing, adding that:

In the meantime, pending any modification of the rule after such re-evaluation, it would seem that any reliance upon it by persons entitled to exercise stock purchase options under employee-stock option plans substantially similar to that here in issue would be ill-advised.¹²⁸

Judge Lumbard again dissented from this holding, reaffirming his belief that rule X-13B-3 should be held to be a valid exercise of the Commission's power.

The majority opinion seems clearly wrong. As pointed out in the *amicus curiae* memorandum of the SEC:¹²⁹

(1) The court had before it a situation in which Congress obviously intended the SEC on the basis of its continuous experience to determine and exempt situations where the possibility of abuse is slight when weighed against interference with otherwise legitimate rights.

(2) The Second Circuit's indication that the Commission's balancing of interests (the interest against insider manipulation for private benefit and the interest against interference with legitimate trading) is not a proper test of commission exemption, and the further indication that if any abuse, however slight, can be envisioned

¹²⁷ 247 F.2d 689, 692-93 (1957).

¹²⁸ *Id.* at 697.

¹²⁹ Reprinted at CCH Fed. Sec. L. Rep., para. 90821, paras. 92575-78 (1957).

by reason of an exemptive rule, the rule is invalid, amounts to writing out of the statute the Commission's rule making power in its entirety. In the words of the memorandum, "We can conceive of no exemptive rule on the basis of which the possibility of insider trading abuses cannot be envisioned."

(3) The exemption of restricted stock option plans was carefully thought out and is just, for, again in the words of the memorandum:

The application of Section 16(b) to the exercise of these restricted stock options might often frustrate the purpose of such plans by turning back to the issuer a profit—based essentially on a long term accretion in value—which the stockholders presumably intended should inure to the holder of the option.¹³⁰

V. ENFORCEMENT

a. *The Right to Sue*

The statute itself gives "any security holder" the right to bring suit to require the payment of insiders' short-swing profits to the corporation. The first case involving section 16(b), *Smolowe v. Delendo Corp.*, established that the statute creates a derivative right of action in every stockholder, "regardless of the fact that he has no holdings from the class of securities subjected to a short-swing operation or that he can receive no tangible benefits, directly or indirectly, from an action because of his position in the security hierarchy." This language was not essential to the disposition of the *Smolowe* case, since the point was not there raised as a defense, but a specific holding to the same effect was made in *Benisch v. Cameron*, where the court said:

[I]t is plain from the reasons set forth in Section 2 of the Act . . . and in the preamble to Section 16(b), that it was primarily intended as an 'instrument of a statutory policy of which the general public is the ultimate beneficiary.' Congress did not intend procedural restrictions to hamper such policy. . . . [Plaintiff did not have to comply with rule 23(b).]¹³¹

The absolute right of any security holder to sue (subject to the "sixty-day notice" provisions), or to intervene in a suit, whether or not he owned his security at the time of the transactions com-

¹³⁰ *Id.* at 92578.

¹³¹ 81 F. Supp. 882, 884-85 (1948). Rule 23(b), Fed. R. Civ. P., requires that the plaintiff in a stockholder's derivative suit must aver that he was a shareholder of the defendant corporation at the time of the transactions of which he complains, or that his shares thereafter devolved upon him by operation of law.

plained of and regardless of his motives, has been re-affirmed by the Second Circuit in the *Mission Corporation* and *Magida* cases, by the Fifth Circuit in *Dottenheim v. Murchison*, and by the Ninth Circuit in the case of *Pellegrino v. Nesbit*.¹³²

The Second Circuit early held in the *Park & Tilford* case that the right to bring suit included the right of a minority shareholder to intervene as plaintiff under rule 24(a)(2) of the Federal Rules of Civil Procedure where necessary to guard against the likely failure of the plaintiff corporation to prosecute diligently a suit for recovery of profits made by one of its own officers, directors, or beneficial owners of more than ten per cent of a class of its securities. The right of intervention was again upheld in *Twentieth Century-Fox Film Corp. v. Jenkins*, where it appeared probable that the corporation involved would not diligently prosecute the suit, and in spite of the fact that plaintiff's interest in the corporation was minute.

The broad nature of the intervention right was finally and completely established in *Pellegrino v. Nesbit*, where the complaining stockholder moved for leave to intervene, after entry of final judgment in favor of plaintiff corporation, for the purpose of appealing the decision. Reversing the trial court's denial of the motion, the Ninth Circuit spoke of a complaining stockholder's right to intervene "as a matter of right" wherever the prosecuting corporation may fail "diligently to prosecute" a suit it has instituted to recover short-swing profits. The court said:

If, subsequent to commencement of suit, a corporation's Board of Directors can determine with finality that prosecution of insiders will not be in the best interests of the company, and thereby foreclose stockholder action, the opportunity for evasion of statutory policy is obvious.¹³³

b. *The "Sixty-day Period"*

Although section 16(b) specifically provides that a complaining stockholder cannot bring suit for the recovery of profits on behalf of the corporation until sixty days after demand on the corporation

¹³² For earlier cases on the immateriality of plaintiff's motives in bringing suit, see notes 38 and 39, *supra*, and accompanying text. The most recent case on the point is *Blau v. Albert*, CCH Fed. Sec. L. Rep. para. 90836 (S.D.N.Y. Dec. 16, 1957).

¹³³ 203 F.2d 463, 467 (1953). The stockholder, though appealing from the trial court's refusal of its motion to intervene, did not seek an extension of the thirty-day statutory period for appeal of the trial court's judgment on the merits. Although the Ninth Circuit decided not to consider the question pending intervenor's action in seeking to appeal, it would appear that his failure to seek an extension of the appeal period probably foreclosed the recovery which would otherwise have been obtained.

to bring suit, it was early held in *Grossman v. Young*¹³⁴ that the sixty-day waiting period was not required where the insider controlled the management of the corporation, demand in such a case presumptively being futile. In the same case it was also held that the waiting period was intended for the benefit of the corporation and not for the benefit of the profiting insider, being designed only to provide the corporation with a reasonable opportunity to institute suit, and that therefore the defendant insider has no standing to raise the question of non-compliance with the sixty-day limitation.

The holding that the profiting insider has no standing to object to plaintiff stockholder's failure to wait out the sixty-day period was reaffirmed in *Benisch v. Cameron*. And *Blau v. Ogsbury* covered the field, holding that (1) plaintiff need not be a stockholder at the time of the transaction complained of; (2) his motives in bringing suit are immaterial; and (3) his failure to observe the sixty-day waiting period cannot be raised by the insider.

Two recent cases from the Southern District of New York have further clarified the nature of the sixty-day period. In *Heness v. Schneider*,¹³⁵ a complaining stockholder brought suit against both the insider and the corporation to recover profits under section 16 (b). The court sustained the motion of the corporate defendant to dismiss the complaint on the ground that the suit was improperly brought within the sixty-day period, since plaintiff stockholder had alleged no facts to justify his precipitate filing and had resisted the motion to dismiss merely by arguing a series of hypothetical situations based on wrongful conduct of the corporation or the insiders. The court said:

If in a given case, the corporate rights may be defeated because of improper conduct or lack of diligence by corporate officers, then such facts should be alleged in the complaint. . . . To permit the commencement of suits prior to the expiration of the specified period where no facts are pleaded to justify it, not only flies in the face of the clear mandate of the law, but would subject a corporation to harrassment by a multiplicity of suits by its security holders, all of whom would be equally entitled to assert corporate right.¹³⁶

¹³⁴ 72 F. Supp. 375 (S.D.N.Y. 1947).

¹³⁵ 132 F. Supp. 60 (S.D.N.Y. 1955); see same case at 132 F. Supp. 64.

¹³⁶ *Id.* at 62-63. Plaintiffs objected to dismissal on the further grounds that their request to the corporation to bring suit was made not entirely for the benefit of the corporation, but also to lay the foundation for the allowance of attorney's fees. The court brushed this objection aside, pointing out that if the plaintiff's activities compelled action by the corporation resulting in the recapture of insider's profits, whether by suit or otherwise, they would be entitled in an independent action to recover their legal expenses for such services.

That the *Henss* case evidenced no change in the courts' general position on the sixty-day period was evidenced in the 1956 case of *Netter v. Asbland Paper Mills, Inc.*,¹³⁷ where the court held that the complaining stockholder could bring his own suit to recover section 16(b) profits without making any demand whatsoever on the corporation to sue, where it was alleged and proved that a demand would have been useless. The futility of such a demand was shown as a matter of law where the profiting insider owned and controlled more than a majority of the corporation's stock, and where he and his family constituted the board of directors and officers of the corporation.

c. *Limitations*

Section 16(b) specifically provides that no suit for the recovery of insider's short-swing profits shall be brought "more than two years after the date such profit was realized." Nevertheless, *Grossman v. Young* early established that a defendant's mere failure to file reports of dealings in his corporation's stock, as required by section 16(a), amounted to fraud, thus calling into play the rule of *Holmberg v. Armbrecht*,¹³⁸ to the effect that into every federal statute of limitations is read the old chancery rule that where a plaintiff has been injured by fraud and remains in ignorance of it without any fault or want of diligence or care on his part, the bar of the statute does not begin to run until the fraud is discovered, though there be no special circumstances or efforts on the part of the party committing the fraud to conceal it from the knowledge of the other party. Several older cases attempted to modify the rule requiring tolling of the statute where reports of insider stock dealings were not timely filed. In *Fistal v. Christman*¹³⁹ the court held that where the defendant has filed a report as required by section 16(a), limitations run, not from the date the report is filed, but from the date of the realization of the profit. And in *Carr-Consolidated Biscuit Co. v. Moore*,¹⁴⁰ it was held that the statute of limitations was not tolled, even though the defendant insider did not file reports under section 16(a) until the SEC brought a lawsuit to compel him to do so, since the president and secretary of the plaintiff corporation had actual knowledge of the transactions complained of at the time they occurred. The court held that in order to rely upon fraud to

¹³⁷ CCH Fed. Sec. L. Rep. para. 90766 (S.D.N.Y. 1956).

¹³⁸ 327 U.S. 392 (1946).

¹³⁹ 13 F.R.D. 245 (W.D. Pa. 1952).

¹⁴⁰ 125 F. Supp. 423 (M.D. Pa. 1954).

toll the two year statute under section 16(b), the plaintiff must show reliance upon defendant's misleading conduct. The *Carr-Consolidated* holding is highly questionable.

A further limitation on the time of suit, evidencing a strict construction of the two-year period, is indicated by *Blau v. Ogsbury*, where the court held that even where the transaction complained of consists of a sale and a subsequent purchase, limitations start to run on the date of the sale, since that is "the date such profit was realized." And in *Dabney v. Atlas Corp.*,¹⁴¹ where an insider sold stock for cash plus an option to buy stock in another corporation, the court held that limitations began to run on the date of the original sale of stock for cash-plus-option, and not on the date the stock of the third-party corporation was acquired or sold. The court pointed out that the exercise of the option and the subsequent sale of the option stock constituted an entirely separate transaction. Profit was "realized" within the meaning of section 16(b) when the original stock was sold for cash and the presumably valuable option to buy other stock.

A return to the principles of *Grossman v. Young*, requiring a tolling of the statute where reports are not timely filed, is indicated by *Blau v. Albert*. There the defendant insider moved for summary judgment on the ground that the plaintiff's action was not commenced within the two-year period from the time that the alleged profits were realized. Defendant attempted to distinguish *Grossman v. Young* on the ground that there was no claim of fraud and that no fraud could in fact have been practiced upon plaintiff since he did not become a stockholder until the last of the insider's reports under section 16(a) were filed. In holding that the plaintiff's action was not barred, the court said:

But the only fraud necessary to invoke the Federal equitable doctrine is a violation of the statutory policy against trading by insiders, concealment of that violation, whether intentional or inadvertent, effectively prevents suit and demands the 'mitigating construction' of the statute of limitations given by the Court in other contexts.¹⁴²

d. Jurisdiction and Venue

*American Distilling Co. v. Brown*¹⁴³ established that exclusive jurisdiction over section 16(b) actions is in the federal courts; the case has never been seriously challenged. Although section 16

¹⁴¹ CCH Fed. Sec. L. Rep. para. 90650 (S.D.N.Y. 1954).

¹⁴² CCH Fed. Sec. L. Rep. paras. 90636, 90637 (Dec. 16, 1957).

¹⁴³ 295 N.Y. 36, 64 N.E.2d 347 (1945).

(b) does not directly provide that an officer, director or beneficial owner "violates" the statute by engaging in short-swing transactions, but merely makes him a constructive trustee of the corporation to the extent of profits, *Gratz v. Claughton*, discussed above, established that, by analogy to general fiduciary principles, the wrong consists in obtaining profits by a short-swing purchase and sale (which the court referred to as "wrongful purchase and sale") or sale and purchase. Thus, when any of the purchases or sales complained of are executed on a national exchange, venue under section 27 to enforce the payment of profits to the corporation may lie within the district where the exchange is located. *Gratz v. Claughton* was followed on this point in *Falco v. Donner Foundation, Inc.*, and in *Blau v. Mission Corp.*, in both of which the Second Circuit upheld venue in the district in which the New York Stock Exchange was located on the ground that "some" of the transactions involved were consummated on the Exchange floor.

Perhaps the most interesting venue case is *Blau v. Lamb*.¹⁴⁴ Plaintiff, a stockholder in Air-Way Industries, Inc., sued the defendants, residents of Ohio, for profits allegedly made by them on a transaction, the "purchase" part of which involved the defendants' acquisition of Air-Way preferred stock in exchange for stock in another corporation, and the "sale" part of which was a conversion, within six months, of the preferred stock into Air-Way common. Both transactions took place in Ohio. Plaintiff alleged venue in the Southern District of New York by virtue of the fact that nine days before the conversion of the preferred into common, defendants had sold a negligible amount of other common stock on the American Stock Exchange. Even though the 100 shares sold on the Exchange were at a price substantially lower than the price at which defendants "purchased" the large block of common stock by conversion of their previously acquired preferred, the court held that venue was properly laid in New York, on the following reasoning.

Under *Gratz v. Claughton*, the mere incidence of the 100-share sale-7,000-share purchase within the six months constituted a violation, whether a profit was made or not; under section 27 of the Securities Exchange Act any action under the act may be brought in any district wherein any act or transaction constituting the violation occurred; and under *Falco v. Donner Foundation*, and *Blau v. Mission Corp.*, one act occurring in a given district is

¹⁴⁴ 20 F.R.D. 411 (S.D.N.Y. 1957).

sufficient to fix venue there with reference to other similar transactions taking place in other districts. Judge Dimock observed in *Blau v. Lamb*:

There probably never was a more tenuous thread of jurisdiction, but I think it holds.¹⁴⁵

The thread apparently does hold, but Judge Hand, in writing the *Gratz v. Claughton* opinion, probably never realized the lengths to which it could be logically extended.

e. Nature of Action, Burden of Proof and Abatement

Arbetman v. Playford early established that a suit by a complaining stockholder to recover short-swing profits for his corporation under section 16(b) is a derivative suit in the nature of an equitable action, and that the plaintiff has his choice of remedies—if the plaintiff does not himself demand a jury trial, the defendant's demand for a jury trial will, upon plaintiff's motion, be vacated.

The case of *Stella v. Graham-Paige Motors Corp.* held that, once plaintiff has made a prima facie showing of a profit made by a defendant insider as a result of short-swing transactions, then the insider has the burden of proving to what extent his profits are less than the maximum prima facie showing, or that they are non-existent. If the defendant's proof leaves the amount of profit uncertain, then judgment is to be rendered against him for the maximum figure. The court remanded the cause, since the lower court had held for the defendant on the ground that it had rebutted the plaintiff's prima facie showing of a profit and the plaintiff had thereafter failed to sustain the burden of proof on showing a profit. On remand,¹⁴⁶ as one might suspect, the lower court again held for the defendant after considering all the evidence, finding that the defendant had sustained its burden of showing no profit.

Pellegrino v. Wright,¹⁴⁷ the only case dealing with the point, held that a section 16(b) action is not penal, and therefore does not abate on the death of the defendant insider but continues against his estate.

VI. ALLOWANCE OF ATTORNEY'S FEES

The *Smolowe* case established at the very outset of insiders' profits litigation the principle that:

¹⁴⁵ *Id.* at 414.

¹⁴⁶ 149 F. Supp. 390 (S.D.N.Y. 1957).

¹⁴⁷ CCH Fed. Sec. L. Rep. para. 90602 (D. Md. 1952).

A stockholder who is successful in maintaining such an action is entitled to reimbursement for reasonable attorney's fees on the theory that the corporation which has received the benefit of the attorney's services [through recovery of the insider's short-swing profits] should pay the reasonable value thereof.¹⁴⁸

The court held that the failure of the corporation to bring a section 16(b) action, and the institution or prosecution of such action by a security holder for the corporation, creates a derivative right of action, with the moving party therefore entitled to attorney's fees out of the sum recovered. The court rejected the contention that since attorney's fees were specifically made recoverable in actions under other sections of the Securities Exchange Act, they were therefore not intended to be recoverable since not specifically made so under section 16(b).

The lower court in *Smolowe* awarded \$3,000.00 attorney's fees although the plaintiff owned only 150 shares out of a total 800,000, so that while he saved the corporation \$18,000.00, his share was only \$3.38. In upholding the trial court's award, the Second Circuit said:

While the allowance made here was quite substantial we are not disposed to interfere with the district court's well considered determination. . . . Since in many cases such as this the possibility of recovering attorney's fees will provide the sole stimulus for the enforcement of section 16(b), the allowance must not be too niggardly.¹⁴⁹

The *Park & Tilford* case approved an allowance of attorney's fees without comment. At the close of the *Park & Tilford* litigation, the ultimate allowance to the plaintiff for attorney's fees amounted to \$69,232.83, plus ten per cent of a payment by one insider on his conversion of 274 shares.¹⁵⁰

In *Dottenheim v. Emerson Elec. Mfg. Co.*,¹⁵¹ the plaintiff-stockholder's attorney had, at plaintiff's instigation, investigated dealings in the corporation's securities by its president. After investigation the attorney had forwarded a letter to the corporation informing it of the president's unlawful profits and demanding that suit be commenced to recover them. The corporation thereupon, without legal action, recovered \$57,872.00 from the president. Two claims were presented: one by the assignee of the attorney's cause of action,

¹⁴⁸ 136 F.2d 231, 241 (1943). (Citing, for comparison, *Hutchinson Box Board and Paper Co. v. Van Horn*, 299 Fed. 424 (8th Cir. 1924); *In re Natural Dry Ginger Ale Corp.*, 9 F. Supp. 1003 (W.D.N.Y. 1935)).

¹⁴⁹ *Ibid.*

¹⁵⁰ CCH Fed. Sec. L. Rep. para. 90413 (S.D.N.Y. 1948). For a discussion of the *Park & Tilford* allowance see Comment, 27 Texas L. Rev. 840, 848-49 (1947).

¹⁵¹ 7 F.R.D. 195 (E.D.N.Y. 1947).

to recover the reasonable value of the attorney's services; the other by the plaintiff stockholder himself, to recover his reasonable attorney's fees. The court rejected the assignee's claim, since there was obviously no available proof that the corporation either expressly hired the dissenting stockholder's attorney, nor were there circumstances from which such an agreement of hire might be inferred. However, the claim brought by the stockholder himself was upheld, on the authority of *Smolowe v. Delendo Corp.* The court rejected the distinction attempted to be made by the defendant that attorney's fees were recoverable by a prosecuting stockholder under section 16(b) only where the prosecuting stockholder's attorney is actually involved in litigation, saying:

It would appear that the purpose of the statute would be as effectively thwarted if such distinction were to be approved as if reimbursement were to be denied entirely. If the objective is the recovery by the corporation of unlawful profits, would it be reasonable to say that a stockholder shall be entitled to all his expenses if he needs to bring suit, but that he shall be denied reimbursement where the same benefit to the corporation has resulted without the necessity of legal proceedings and at less expense? This would be penalizing efficiency and expediency.¹⁵²

The court in *Dottenheim* pointed out that the reasonableness of the attorney's fees requested is a matter for the court. The cited case merely denied a motion to dismiss; on later hearing the court allowed \$1,000.00 (as against a claim for \$14,468.00), the comparative smallness of the fee being attributable to the fact that the attorney merely made a simple investigation and wrote one letter, and to the court's belief that the corporation would have acted itself if left entirely alone, its reason for delay being to ascertain whether or not the *Smolowe* case was to be qualified by later holdings.¹⁵³

In *Berkey & Gay Furniture Co. v. Wigmore*¹⁵⁴ the court granted a motion for intervention by a minority stockholder with the condition that if the corporation, which had already brought suit, recovered the insider's profits, it would not have to pay the intervenor's attorney for services which its own counsel also rendered.

The courts necessarily continue to recognize that in many cases, in the words of the *Smolowe* case, "the possibility of recovering attorney's fees . . . provides the sole stimulus for the enforcement

¹⁵² *Id.* at 197.

¹⁵³ See Comment, 27 Texas L. Rev. 840, 848 (1947).

¹⁵⁴ CCH Fed. Sec. L. Rep. para. 90376 (S.D.N.Y. 1947).

of section 16(b)"¹⁵⁵ However, the last two cases to comment on attorney's fees indicate a growing awareness of and concern for the inherent evils in the present system, in which the section 16(b) suit benefits the complaining stockholder hardly at all, but can greatly benefit his attorney. Thus in many cases attorneys may engage in champertous conduct in order to recover fees. Equally dangerous is the fact that, once the suit is filed, the stockholder's attorney can often recover a fee by settlement with a defendant insider. If he wishes to do so (as he usually will), he is no longer effectuating the congressional intent to protect the interests of the stockholders and the corporation; and the effectuation of this intent is the only reason for the allowance of attorney's fees in the first place.

Thus, in *Fistal v. Christman* the court refused to permit the dismissal of a stockholder's action under section 16(b) where the agreement for dismissal was conditioned upon the defendant's payment of \$2,500.00 to the plaintiff for the costs and expenses (including attorney's fees) of maintaining the action. The plaintiff's attorney prepared his request for approval of the dismissal carefully, urging as reasons therefor: (1) that there was some question as to whether the venue of the action was proper; (2) the difficulty for the plaintiff to prove that the insider actually realized profit from the transaction; and (3) that even in the event of successful litigation, the amount of recovery would be so small that it would hardly cover expenses. At the argument the corporation stated that it did not object to the proposed dismissal. In spite of the above, however, the judge in a carefully reasoned opinion refused to approve the dismissal of the action, since it was conditioned on the plaintiff's attorney receiving a payment from the defendant. After discussing the fact that the allowance for a stockholder's attorney's fees in most, if not all, instances provided the only impetus to enforcement of section 16(b),¹⁵⁶ the court said:

As long as the interests of the security holders, the corporation, and the

¹⁵⁵ 136 F.2d 231, 241 (1943), discussed above. And as stated in *Fistal v. Christman*, 133 F. Supp. 300, 304 (S.D.N.Y. 1955):

"But the statute does not offer any hope of reward to the security holder who brings an action under Section 16(b) other than the satisfaction derived from a good deed well done and the extent to which the value of his interest in the corporation might be increased by reason of a recovery. Perhaps because of this lack of an appreciable material reward, or because most investors have neither the means or knowledge needed to engage in an investigation for the purpose of determining if the grounds for an action under Section 16(b) exist, attorneys have largely pre-empted their position as enforcers of Section 16(b)."

¹⁵⁶ For the court's statement, see note 149, *supra*.

attorney for the plaintiff-security holder parallel each other there is no reason to fear that this reliance is misplaced. These interests do parallel each other when the fee of the attorney for the plaintiff-security holder is contingent upon his success in imposing the statutory penalty on the 'insider' and is payable from the corporation's recovery. Under these circumstances the self-interest of the attorney for the plaintiff-security holder corresponds exactly with the interests of the public, the security holders and the corporation.

But once the attorney for the plaintiff-security holder can recover a fee from the defendant 'insider' his interests and those of the public, the security holders, and the corporation diverge. For his interest in the enforcement of Section 16(b) is then affected by the fact that he can profit from the dismissal of an action on condition that the 'insider' pay him a fee, and his reliability as an enforcer of the statutory policy is susceptible of doubt.

I therefore believe that the policy and purposes of Section 16(b) are best served by disapproval of any dismissal of an action under that statute that is conditioned on the plaintiff's attorney receiving any payment from the defendant 'insider.' Since the proposed dismissal is so conditioned, it is hereby disapproved.¹⁵⁷

In *Magida v. Continental Can Co.*, the lower court had refused to allow an amendment to the defendant's answer to include an alleged defense of champerty. The lower court permitted an offer of proof, principally by depositions, to show that plaintiff's attorney was the real party in interest, that his sole motive in prosecuting the action was to obtain a counsel fee, and that no true relation of attorney and client existed. The Second Circuit noted that the true facts of the arrangement between the attorney and client were "heavily obscured by numerous invocations of the attorney-client privilege by the attorney of record,"¹⁵⁸ but in line with the philosophy of earlier decisions, held that even if the defense of champerty were fully proved, it would be insufficient in law to defeat the suit, since:

The relationship between his attorney and the plaintiff, who is the mere vehicle of recovery, cannot defeat the rights of the corporation and other stockholders, to whom the recovery accrues. . . . If there has been a violation of N. Y. Penal Law, Section 274, as alleged, offenders are liable to its criminal sanction. But the public policy of New York cannot nullify this federally created right established for the effectuation of a broad federal policy.

¹⁵⁷ 133 F. Supp. 300, 304-05 (1955).

¹⁵⁸ 231 F.2d 843, 847-48 (1956), referring to the record in the lower court, *Magida v. Continental Can Co.*, 12 F.R.D. 74 (S.D.N.Y. 1951).

The court however went on to say:

Judge Ryan has specifically reserved these matters as alleged by Continental [champerty] for a later consideration in connection with the allowance of a reasonable attorney's fee. A showing of misconduct is naturally pertinent to the determination of an appropriate fee.¹⁵⁹

The total recovery to the corporation in the *Magida* suit amounted to \$47,000.00. The petition for attorney's fees was for \$23,500.00. On the subsequent hearing on attorney's fees¹⁶⁰ the trial court affirmed its inherent power to investigate and determine whether the plaintiff's attorney had been guilty of such misconduct as to justify withholding his fee. The court went on to say that there was no direct proof of a champertous agreement, and:

[T]he retainer of petitioner was oral, and although it is very likely that petitioner did pay the expenses of the suit in return for his retainer and fee, I have reluctantly come to the conclusion that the probable existence of such conduct in these suits should not bar the attorney from receiving an allowance. . . . The personal feelings of the court on the subject aside, its duty is to aid in the enforcement of the statute by encouraging such suits and by making an allowance which is not 'too niggardly' and which will often provide 'the sole stimulus for the enforcement of Section 16(b)'. . . . It is for the Congress, if it sees fit, to curb the evil side effects of the statute by imposing appropriate restrictions.¹⁶¹

The court, however, cut the attorney's fees to \$12,000.00, which though certainly a substantial amount, was probably by no means exorbitant, as indicated by the fact that there are five district court opinions, the opinion of the court of appeals, and the denial of writ of certiorari appearing in the books. There is little risk in predicting that the courts will hereafter be forced to re-examine the allowance of attorney's fees in section 16(b) cases unless Congress itself passes legislation, or unless the severe sanctions of the section eventually remove insiders' profits entirely from the economic picture—both doubtful results.

VII. TAX TREATMENT

When the insider pays over short-swing profits to the corporation as a result of the operation of section 16(b), each has a tax problem. The insider wishes to take a deduction for the payment as a business expense or loss, or at the very least to add the

¹⁵⁹ Id. at 848.

¹⁶⁰ *Magida v. Continental Can Co.*, CCH Fed. Sec. L. Rep. para. 90777 (S.D.N.Y. 1956).

¹⁶¹ Id. at 92390-91.

amount of the payment to the basis of his remaining stock. The corporation, of course, desires not to consider the payment as taxable income. Both questions appeared to be settled in 1951 and 1952. *Park & Tilford Distillers Corp. v. United States*¹⁶² held that payments of insiders' profits were taxable income to the corporation receiving them, as a "windfall." *William F. Davis, Jr.*¹⁶³ held that the insider paying his profits over to the corporation was not entitled to a deduction even though he had paid tax on the gain when realized, since to allow it would frustrate the sharply defined public policy of section 16(b). Although the Tax Court divided nine to seven in the *Davis* case, most practitioners interpreted it as establishing the rule that no deduction or loss could be taken for the payment of insiders' profits to the corporation under any circumstances.¹⁶⁴ This belief was re-enforced by Judge Tietjens' decision in *William L. Dempsey*,¹⁶⁵ in which he merely detailed certain facts showing that petitioner had realized short-swing profits and had paid them to the corporation, claiming a deduction at the time of payment, following his statement of facts by the following opinion (quoted in full):

The facts in this case differ in no material respects from those in *William F. Davis, Jr.* [citation omitted], and we consider ourselves bound by the decision there. Accordingly, decision will be entered for the respondent.¹⁶⁶

The Commissioner's position that insiders' profits are taxable income to the corporation receiving them, which had been upheld in the *Park & Tilford Distillers* case was again upheld in *General Investors, Inc. v. Commissioner*¹⁶⁷ and in *Noma Elec. Corp.*¹⁶⁸ The Supreme Court granted certiorari in the *General American Investors* case and, in a brief decision by Chief Justice Warren, held that such payments were indeed taxable income to the corporation.¹⁶⁹

¹⁶² 107 F. Supp. 941 (Ct. Cl. 1952), cert. denied, 345 U.S. 917 (1953).

¹⁶³ 17 T.C. 549 (1951).

¹⁶⁴ For example, see Loss, Securities Regulation 579 (1955 Supp.).

¹⁶⁵ 10 T.C.M. 936 (1951).

¹⁶⁶ Id. at 938.

¹⁶⁷ 211 F.2d 522 (2d Cir. 1954).

¹⁶⁸ 12 T.C.M. 1 (1953).

¹⁶⁹ U.S. 434 (1955). The Court stated that certiorari had been granted only because of a possible conflict with *Commissioner v. Glenshaw Glass Co.*, and the decision was based on the reasoning in the *Glenshaw Glass* case, decided the same day, 348 U.S. 426 (1955), that the inclusion in the general definition of gross income (Int. Rev. Code of 1939, § 22(a); Int. Rev. Code of 1954, § 61) of the phrase "or gains or profits and income derived from any source whatever" indicated a congressional intent to tax income from whatever source derived, and included such "instances of undeniable accessions to wealth, clearly realized, and over which the taxpayers have complete dominion" as triple damages under the anti-trust statutes, as in *Commissioner v. Glenshaw Glass Co.*, and § 16(b) insiders' profits, as in *General Am. Investors Co. v. Commissioner*.

But in the corollary area of deductibility to the insider of the payments made to the corporation, the case of *William F. Davis, Jr.*, after apparently becoming strongly entrenched as a leading authority, turned out to be a strong man with a glass chin. In 1952 the Treasury Department, relying on the *Davis* case, formally ruled that no deduction could be taken by an insider for the amount of payments made to his corporation in accordance with section 16(b) of the Securities Exchange Act, nor could such amount be added to the basis of securities retained by him.¹⁷⁰ And in 1955, in *Robert Lehman*,¹⁷¹ the Tax Court detailed another set of facts showing liability under section 16(b) imposed although the defendant was innocent of any wrongdoing, and a subsequent attempt by the defendant to take a deduction for the profit repaid to the corporation, then disposed of the issue with the following brief words:

This issue was extensively discussed in *William F. Davis, Jr.*, 17 T.C. 549 (1951), and a holding reached adverse to petitioner. That case is dispositive of this issue and we hold that no deduction is allowable to petitioner with respect to such payment.¹⁷²

It thus appeared that all section 16(b) payments by the insider to his corporation were taxable to the corporation and non-deductible to the insider.

But at the end of 1956 the deductibility question was thrown into unexpected and almost complete uncertainty by the full tax court, in *Laurence M. Marks*.¹⁷³ Petitioner was an influential investment banker in New York, engaged for over forty years in the business of underwriting and dealing in securities. Since 1945 he had been a director of Shamrock Oil and Gas Corporation, his firm dealing in Shamrock's stock in its normal course of business. In 1947 an issue of Shamrock stock was made on the floor of the New York Stock Exchange. The issue was unsuccessful, and petitioner's firm purchased 14,800 shares remaining unsold in order to avoid an unfavorable effect on the value of Shamrock stock

¹⁷⁰ I.T. 4069, 1952-1 Cum. Bull. 28.

¹⁷¹ 25 T.C. 629 (1955).

¹⁷² *Id.* at 635. The point above discussed involved Mr. Lehman's directorship in Pan-American Airways Corp. The case is additionally interesting since it also dealt with Mr. Lehman's receipt of the whiskey purchase warrants which were the subject of *Park & Tilford, Inc. v. Schulte*. On this point the court held Mr. Lehman entitled to long-term capital gain treatment upon his disposition of the whiskey purchase warrants after holding them more than six months, against the Commissioner's contention that Park & Tilford was anticipatorily assigning income and that Mr. Lehman should therefore have treated his profits on their sale as ordinary income.

¹⁷³ 27 T.C. 464 (1956).

already in the market. The firm disposed of these shares over a period of several months.

On another occasion the firm bought 4,500 shares of Shamrock from a trust company, disposing of them to its customers in the regular course of business. On a third occasion the firm joined an underwriting group headed by another corporation, participating in an issue of Shamrock stock to the extent of 10,000 shares; petitioner did not want to participate but feared that his refusal would prejudice the success of the issue. On a fourth occasion petitioner's firm purchased 5,000 shares from and at the request of a good customer, taking several months during 1948 to dispose of this stock in an orderly manner. The firm realized a gross profit in the amount of \$45,313.05 from the above dealings and reported the profit as ordinary income. Petitioner included his share of the profits (\$17,672.08) as ordinary income in 1948 and 1949.

Some time later the SEC indicated to Shamrock that it should recover from the petitioner his share of the profits. Although petitioner's counsel advised him that, while there was substantial doubt, he was probably not liable to the company under section 16(b), the petitioner agreed with the other directors of Shamrock that avoidance of litigation was to the best interest of all concerned and, without admitting liability, paid Shamrock \$17,672.08 in voluntary settlement of the claim. Petitioner never traded or dealt in Shamrock stock for his own account while a director, but shortly after becoming a director he purchased 4,000 Shamrock shares, which he still owned at the time of the Tax Court decision.

The Tax Court, with three dissents, held that petitioner was entitled to a deduction for the amounts paid to Shamrock, as a business expense allowable under section 23(a) of the 1939 Code. The court said that in *William F. Davis, Jr.* it had not ruled that payments made in accordance with section 16(b) of the Securities Exchange Act were ipso facto non-deductible, but that the *Davis* case merely followed the rule that if, under the facts of each individual case, a sharply defined public policy would be violated by allowing a deduction, the deduction would be denied. The court pointed out that in the present case petitioner never admitted liability under section 16(b), no determination was ever made by the SEC or any other tribunal that petitioner had violated section 16(b), and that under the circumstances the allowance of the deduction sought by petitioner would not frustrate any sharply defined public policy. The dissenters were unable to distinguish *Marks* in principle from *Davis*.

As a result of the *Marks* case, there is a wide uncharted area of varying fact situations, some of which may produce deductibility of insider's profits paid to the insider's corporation, and others which will produce non-deductibility. Obviously it will take many lawsuits to draw the line.¹⁷⁴

VIII. SUMMARY

The first case arising under section 16(b), *Smolowe v. Delendo Corp.*, established a pattern of broad interpretation to curb abuses by corporate insiders of their positions of trust. Subsequent decisions up to this time have with almost no exceptions evidenced a continued determination by the courts to effectuate the congressional policy of protection against misconduct. The courts still have not been able to establish a dividing line between transactions which constitute "sales" and "purchases" and those which do not, and find themselves faced with the growing problem of the effect of a liberal allowance of attorney's fees in fostering champerty. The Tax Court has unexpectedly confused the question of deductibility by the profiting insider of payments made to his corporation, and many other troublesome points under section 16(b) have not as yet been presented.

The last few years have witnessed the entry of courts other than those of New York into the field of section 16(b) litigation, with at least the circuit courts showing an excellent understanding of the principles and philosophy of the short-swing profits provisions.

The Commission regulations issued and amended during the past few years seem well-adjusted to social and economic realities and

¹⁷⁴ Petitioner in the *Marks* case claimed his deduction either as a business expense under § 23(a), Int. Rev. Code of 1939 (now § 62, Int. Rev. Code of 1954), or as a loss incurred in trade or business under § 23(e) (now § 65). Since the court sustained the deduction under 23(a), it did not reach the question of whether a deduction may ever be claimed for profits paid to a corporation under § 16(b) of the Securities Exchange Act by an insider who is not in the investment business, and who therefore must rely upon § 23(e) for his deduction.

Since *Marks* had reported his profits as ordinary income, the allowance of the deduction did not give him any extra tax benefits. In the *Davis* case the petitioner had reported his profits as long-term capital gain, and thus the allowance of the deduction would not only have made him whole, as far as taxes were concerned, but would have given him a profit. The courts will thus be faced with an interesting problem, when and if they have a case in which the facts bring the taxpayer within the rule of the *Marks* case, but he has reported his profits as long-term capital gain. There do not seem to be any grounds for allowing the taxpayer in such a case to deduct the amount of the payment to the corporation from the basis of his remaining stock (in lieu of taking a deduction); there seems to be some merit in Judge Murdoch's dissent in the *Davis* case, proposing that a deduction be denied but that petitioner be allowed to amend his returns for the years in which he reported profit, so as to deduct the amount of the payment to the corporation in such years.

more importantly, appear eminently just. As has always been the case in section 16(b) litigation, only the pure are haled into court—and, at that, only the pure who have some additional claim to mercy. It thus appears that the harsh, objective, “no excuses taken” rule of section 16(b) continues to perform the purpose for which it was enacted. For a rule admittedly crude, it has served remarkably well, and it is to be hoped that not only will the courts continue in as satisfactory a manner as heretofore to effectuate the congressional purposes under the present law,¹⁷⁵ but also that the SEC will soon win its long, though intermittent and sometimes desultory fight for extension of this and other salutary provisions of the regulatory acts to at least the larger companies without listed securities.¹⁷⁶

¹⁷⁵ While the Second Circuit has developed tremendous competence in this field, its recent challenge to the power of the Securities Exchange Commission to promulgate exemptive rules is ill-founded, and could tend to subvert the congressional purpose.

¹⁷⁶ Currently pending before Congress are Senate Bills 594 and 1168. S. 1168 was reported favorably, with amendment, on July 24, 1957. It would subject to the provisions of § 16(b) the officers, directors and principal stockholders of certain larger companies without securities listed on a national exchange, a desirable expansion of the act.