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Section 16(b) of the Securities and Exchange Act — Unwary Purchaser

I. Background and Application

A corporate officer or a majority stockholder stands in an advantageous position to profit from inside information which is not available to the public. The abuses wrought by insiders in making a "quick kill" on the market historically have been flagrant and widespread,[1] and the necessity for proof of bad faith and actual use of such information was a formidable obstacle to would-be litigants. Consequently, a new mode of attack was formulated by section 16(b) of the Securities Exchange Act of 1934,[2] under the theory that once the possibility of profit was removed such trading by insiders would cease.[3]

Section 16(b) provides that benefits obtained by an insider from transactions in equity securities of the corporation with which the insider is affiliated[4] can be recovered by the issuing corporation or by any security holder suing in behalf of the corporation. The section

[1] Heli-Coil Corp. v. Webster, 352 F.2d 156, 160 n.5 (3d Cir. 1965); Smolowe v. Delendo Corp., 136 F.2d 231, 235 (2d Cir. 1943), *cert. denied,* 320 U.S. 751 (1943); 2 Loss, Securities Regulation 1037 (2d ed. 1961); Rubin & Feldman, *Statutory Inhibitions Upon Unfair Use of Corporate Information by Insiders,* 95 U. Pa. L. Rev. 648 (1947).

[2] 15 U.S.C. § 78p(b):

> "For the purpose of preventing the unfair use of information which may have been obtained by such beneficial owner, director, or officer by reason of his relationship to the issuer, any profit realized by him from any purchase and sale, or any sale and purchase, of any equity security of such issuer (other than an exempted security) within any period of less than six months, unless such security was acquired in good faith in connection with a debt previously contracted, shall inure to and be recoverable by the issuer, irrespective of any intention on the part of such beneficial owner, director, or officer in entering into such transaction of holding the security purchased or of not repurchasing the security sold for a period exceeding six months. Suit to recover such profit may be instituted at law or in equity in any court of competent jurisdiction by the issuer, or by the owner of any security of the issuer in the name and in behalf of the issuer if the issuer shall fail or refuse to bring such suit within sixty days after request or shall fail diligently to prosecute the same thereafter; but no such suit shall be brought more than two years after the date such profit was realized. This subsection shall not be construed to cover any transaction where such beneficial owner was not such both at the 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."

[3] Cook & Feldman, *Insider Trading Under the Securities Exchange Act,* 66 Harv. L. Rev. 385 (1953).

[4] Section 16(b) of the Securities Exchange Act of 1934 applies to "every person who is directly or indirectly the beneficial owner of more than 10 per centum of any class of any equity security" which is registered on a national exchange or which is required to be registered with the Commission pursuant to § 12(g). 15 U.S.C. § 78p(a) (1965).

deals only with "short swing" trading in which securities have been purchased and sold (or vice versa) within a six month period, the time when most abuses were found to have occurred. Section 16(b) provides a simple, effective,[5] mechanically applied standard.[6] All that need be shown is a purchase and sale by an insider within the six month period.

Some transactions, however, escape the coverage of section 16 (b).[7] The section does not cover situations in which the insider buys and then sells (or vice versa) exactly six months and one day later,[8] or in which the insider gives "tips" to family members or to an insider of another corporation in return for similar information about the other corporation.[9] Also, one who is an insider by virtue of his position and who buys stock and then severs his relationship with the issuing company does not come within the express provisions of section 16(b).[10] Yet bona fide transactions by insiders involving no unfair use of inside information have come within the ban of the act.[11]

[5] Loss, *op. cit. supra* note 1, at 1043. Section 12(g) now requires registration for any issuer having total assets exceeding $1,000,000 and a class of equity security held of record by 500 or more shareholders. Section 16(b) also applies to a person who is a director or an officer of the issuer.

[6] "Congress intended the test to be an entirely objective one." Heli-Coil Corp. v. Webster, 352 F.2d 156, 165 (2d Cir. 1965). "[T]he only remedy which its framers deemed effective for this reform was the imposition of a liability based upon an objective measure of proof." Smolowe v. Delendo Corp., 136 F.2d 231, 235 (2d Cir. 1943), *cert. denied,* 320 U.S. 751 (1943). "Its fundamental purpose, moreover, is to make disgorging of insiders' profits almost automatic." Rubin & Feldman, *Statutory Inhibitions Upon Unfair Use of Corporate Information by Insiders,* 95 U. PA. L. REV. 468, 473 (1947). See 40 A.L.R.2d 1358 (1955).

[7] "Congress recognized that section 16(b) would not correct all the practices thought to be evil; obviously the six month limitation alone 'let many fish out of the net' since the tax laws tend to encourage a holding period longer than six months. The statute makes an honest, if not honorable man out of the insider in that period." Adler v. Klawans, 267 F.2d 840, 845 (2d Cir. 1959).

[8] Loss, *op. cit. supra* note 1, at 1042; Cole, *Insiders' Liabilities Under the Securities Exchange Act of 1934,* 12 Sw. L.J. 147, 150 n.22 (1958).

[9] *Ibid.*

[10] Loss, *op. cit. supra* note 1, at 1060.

[11] In Blau v. Lehman, 286 F.2d 786 (2d Cir. 1960), *aff'd,* 368 U.S. 403 (1962), an investment firm purchased stock in a corporation in which one of the firm's partners served as a director. This purchase was accomplished without seeking that partner's advice, and indeed, without his knowledge. The court held that despite his innocence and good faith, the inside partner had to divest himself of his pro rata share of the profits made when the firm sold the stock in the course of its business. In Arkansas Louisiana Gas Co. v. W.R. Stephens, 141 F. Supp. 841 (W.D. Ark. 1956), an investment dealer and broker held more than ten percent of the shares in a corporation and later purchased more shares, largely to fill orders of customers, who were charged the prevailing market price of shares at the time the order was completed. The court held that brokers and dealers were not excluded from § 16(b) and that this company must divest itself of the profits realized by the increase in market value between the original purchase date and the date of the sale. It should be noted that Congress has manifested its realization of the unfairness of such a decision by passing § 16(d) which removes a dealer from the scope of § 16(b). 15 U.S.C. § 78p(d) (Supp. 1965). In Magida v. Continental Can Co., 231 F.2d 843 (2d Cir. 1956), *cert. denied,* 351 U.S. 972 (1956), a parent corporation purchased common stock

In addition, *Smolowe v. Delendo Corp.*[12] has laid down the severe "lowest price in-highest price out" rule in which any profit realized on any single pair of buy and sell transactions must go to the issuing corporation. The shares of lowest cost to the insider will be paired with whatever shares have been sold at the highest price by the insider within six months of that acquisition.[13] Thus, shares are fungible and lose their individual identity. If the rule were otherwise, an insider could safely speculate by maintaining a block of stock for a period greater than six months and then disposing of these certificates, despite the fact that he might have purchased other shares within the six month period.

II. WESTERN AUTO SUPPLY CO. v. GAMBLE-SKOGMO, INC.[14]

Gamble-Skogmo, Inc., an insider corporation holding more than ten per cent of the stock of a subsidiary, Western Auto Supply Company, purchased an additional 32,000 shares of the subsidiary for the avowed purpose of contributing as much of this stock as would be necessary to satisfy the insider's outstanding obligation to its profit-sharing stock bonus trust. The exact amount of its obligation was at that time unascertained; a week later, upon determination of the precise amount, the insider transferred 25,942 shares, plus a small amount of cash, to the trust. The market value of the shares remained unchanged during this period; so no profit was realized by the insider.[15] A civil anti-trust suit was later instituted against the insider in order to force it to divest itself of its holdings in the subsidiary. Within six months of the purchase of the 32,000 shares, the insider sold its entire holdings in the subsidiary; the trust, however, continued to hold its shares. A successor corporation of the subsidiary invoked section 16(b)[16] and demanded that the insider

of its subsidiary and within six months sold a much larger number of shares. The court determined that the sale was made at the request of the subsidiary and was to its advantage. Nevertheless, the court held that the parent came within the prohibitory language of § 16(b), even though the subsidiary had in fact benefited by the transaction.

[12] 136 F.2d 231 (2d Cir. 1943), *cert. denied*, 320 U.S. 731 (1943).

[13] The *Smolowe* rule has been followed in numerous cases. Walet v. Jefferson Lake Sulphur Co., 202 F.2d 433 (5th Cir. 1953), *cert. denied*, 346 U.S. 820 (1953); Gratz v. Claughton, 187 F.2d 46 (2d Cir. 1951); Steinberg v. Sharpe, 95 F. Supp. 32 (S.D.N.Y. 1950), *aff'd*, 190 F.2d 82 (2d Cir. 1951); Blau v. Hodgkinson, 100 F. Supp. 361 (S.D.N.Y. 1951).

[14] 348 F.2d 736 (8th Cir. 1965), *cert. denied*, 382 U.S. 987 (1966).

[15] Western Auto Supply Co. v. Gamble-Skogmo, Inc., 231 F. Supp. 456, 460 (D. Minn. 1964).

[16] The successor inherited the chose in action by virtue of statutory law, and common law, under which a tortious claim for protection of property rights survived although the injured party had expired. Western Auto Supply Co. v. Gamble-Skogmo, Inc., 348 F.2d 736 (8th Cir. 1965), *cert. denied*, 382 U.S. 987 (1966).

turn over profits obtained from 32,000 of the shares which had just been sold by the insider. The insider surrendered the profits it had realized on 6,058 of the original 32,000 shares, which had not been transferred to the trust, and denied liability for any greater amount.

The district court held that the insider had acted merely as a *conduit* in purchasing the shares for the trust; therefore, the insider was correct in turning over to the successor only the profits it had realized on the retained 6,058 shares. The court of appeals reversed, holding that all the shares in the subsidiary were fungible and that those transferred to the trust could not be segregated. The insider was ordered to turn over to the successor profits and dividends obtained by the insider from the sale of the entire 32,000 shares, plus interest.

III. NATURE OF A "PURCHASE" AND A "SALE"

Since a violation of section 16(b) hinges upon a sale within six months of a purchase, a matter of prime importance in *Gamble-Skogmo* was whether the insider was actually a "purchaser" and "seller" within the ambit of the act. The lower court determined that Gamble-Skogmo, acting as a conduit, was not a "purchaser." The court of appeals rejected the conduit argument and found that a "purchase" had occurred.

The Securities Exchange Act broadly defines a "purchase" as including "any contract to buy, purchase, or otherwise acquire,"[17] and a "sale" as "any contract to sell, or otherwise dispose of" a security.[18] These statutory definitions have been broadly applied in most section 16(b) cases; for instance, in *Park & Tilford v. Schulte,*[19] the court determined that a conversion of preferred to common stock was a "purchase". However, these statutory definitions have been tempered in a few instances. In two subsequent stock conversion cases, heard by courts of other circuits, no "purchase" was found. In *Ferraiolo* v. *Newman,*[20] the first of these, the court stated that

[17] 14 U.S.C. § 78c(a)(13) (1963).

[18] 15 U.S.C. § 78c(a)(14) (1963). The Commission may exempt by its rules and regulations any situation it considers not to be within the scope of § 16(b). 15 U.S.C. § 78p(b) (1963). However, no exemption exists for a "conduit" transaction.

[19] 160 F.2d 984 (2d Cir. 1947), *cert. denied,* 332 U.S. 761 (1947). The defendants were the owners of the majority of the common stock and a large amount of preferred stock of the plaintiff corporation. The corporation, which was found to be controlled by the defendants, served notice of the redemption of the preferred, and the defendants converted to the more valuable common stock and then sold this within six months of the conversion period.

[20] 259 F.2d 342 (6th Cir. 1958), *cert. denied,* 359 U.S. 927 (1959). The defendant acquired convertible preferred stock and then became a director in the issuing corporation. He converted the preferred stock to common stock of equal value rather than accepting

"every transaction which can reasonably be defined as a purchase will be so defined, if the transaction is of a kind that can possibly lend itself to the speculation encompassed by section 16(b)."[21] The second case, *Blau* v. *Max Factor & Co.,* held that no "purchase" had occurred since the conversion did not interrupt the continuity of the insiders' original investment.[22] Moreover, in two cases subsequent to *Park & Tilford,* involving gifts, section 16(b) was held inapplicable because no "sale" was involved.[23] Section 16(b) was also held inapplicable to an acquisition resulting from the reclassification of shares;[24] nor was it held applicable to an exchange for shares of a holding company which is a wholly-owned subsidiary of the insider.[25]

The foregoing cases dealing with the problem of "purchase" and "sale" are among the few to escape section 16(b). These exceptional cases dealt with conversions, gifts, a reclassification, and an exchange; and these are clearly distinguishable from the conduit situation in *Gamble-Skogmo.* However, *Ferraiolo* v. *Newman,* although a conversion case, suggests an application wider than its limited fact situation. Its "purchase" definition implies that a subjective consideration should be given to the facts of each case, and thus it might be argued that section 16(b) should not encompass a conduit transaction where no opportunity for speculation exists.[26] But a recent decision handed down by another circuit has discredited the *Newman* case and has employed a strict, objective test.[27] The *Newman*

a low redemption price. He then sold this within six months of the conversion. The court found that no "purchase" had taken place since the preferred and the common were economic equivalents and the conversion was in a sense involuntary because the owner would otherwise suffer substantial economic loss. *Cf.* Petteys v. Northwest Airlines, Inc., 246 F. Supp. 526 (D. Minn. 1965).

[21] *Id.* at 345. (Emphasis added.)

[22] 342 F.2d 304 (9th Cir. 1965). Insiders traded common stock which they had held for years for Class A stock, which had equal voting and liquidation rights with the common, but on which the directors could declare greater dividends. They then sold this newly acquired stock at a large profit within six months of the conversion.

[23] Truncale v. Blumberg, 80 F. Supp. 387 (S.D.N.Y. 1948). An insider exercised a stock option and gave the stock to charities within six months. The insider actually profited by the disposal because he received a tax deduction as a result of his charitable gift. The court, however, held that there were neither "sales" nor "profits" under § 16(b). Shaw v. Dreyfus, 172 F.2d 140 (2d. Cir. 1949) (non-charitable gifts of shares within six months of acquisition did not constitute "sales"). However, it should be noted that in both cases neither the donor-insider nor the donees actually sold any stock within six months of the donor's acquisition.

[24] Roberts v. Eaton, 212 F.2d 82 (2d Cir. 1954), *cert. denied,* 348 U.S. 827 (1954). The defendants were a family group which owned 45.9% of the common stock of a company. The stock holders voted to reclassify the common stock into common stock with a lesser par value and preferred stock; this was done and thereafter the defendants sold their stock within six months.

[25] Blau v. Mission Corp., 212 F.2d 77 (2d Cir. 1954), *cert. denied,* 374 U.S. 1016 (1954).

[26] See note 15 *supra.*

[27] Heli-Coil Corp. v. Webster, 352 F.2d 156 (3d Cir. 1965).

case stands alone,[28] and the application of its holding seems limited to its particular fact situation.[29]

IV. CONCLUSION

Gamble-Skogmo attempted unsuccessfully to avoid section 16(b) by denying that a "purchase" and a "sale" had occurred. In light of *Smolowe,* the determination that a "sale" had taken place was almost a foregone conclusion. Since the holding in *Smolowe* that shares are fungible, subsequent cases have never permitted the segregation of particular stock certificates. Therefore, the fact that Gamble-Skogmo had purchased *some* shares and then sold *any* shares within a six month period would be sufficient to raise section 16(b) liability, despite the fact that the share certificates disposed of were actually different from those acquired less than six months before.

The question of whether a "purchase" had occurred is more difficult. For several reasons, the finding of a "purchase" was a correct one. First, as has been pointed out, the fact situation in *Gamble-Skogmo* does not fit within those of the few cases previously discussed which have determined that no "purchase" had occurred. Second, it appears that Gamble-Skogmo could not have availed itself of the lenient, subjective "purchase" definition laid down by the *Newman* case because there was a chance for speculation; Gamble-Skogmo was not required to satisfy its obligation via a transfer of stock,[30] and under certain circumstances it might have decided to retain the entire 32,000 shares. Also, there might have been some advantage realized by Gamble-Skogmo through increased control of the subsidiary due to the vesting of a large block of shares in a non-adverse trust fund. Moreover, the conduit argument[31] posed by *Gamble-Skogmo* is difficult to accept because of the inaccuracy of

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[28] "[T]he trial courts and the courts of appeals have taken two divergent roads to what they deem to be the same end. One road leads out of Park and Tilford; the other from Ferraiolo v. Newman. The test of the first is very largely objective; the second, in part at least, seems subjective . . . . Congress intended the test to be an entirely objective one." Heli-Coil Corp. v. Webster, 352 F.2d 156, 164-165 (3d Cir. 1965).

[29] "No good purpose would be achieved in attempting to reconcile Park and Tilford, Inc. v. Schulte and Ferraiolo v. Newman . . . . Obviously, the facts in those two cases are different. The more recent cases have tended to follow the stricter rule laid down in Park and Tilford, Inc. v. Schulte . . . ." Petteys v. Northwest Airlines, Inc., 246 F. Supp. 526, 529 (D. Minn. 1965).

[30] Western Auto Supply Co. v. Gamble-Skogmo, Inc., 348 F.2d 736, 742 (8th Cir. 1965), *cert. denied,* 382 U.S. 987 (1966).

[31] The Securities and Exchange Commission, in its amicus curiae brief, stated that if Gamble-Skogmo had not been so careless in determining the amount of its indebtedness, the Commission might not have found any objection to the transaction. Western Auto Supply Company v. Gamble-Skogmo, Inc., 348 F.2d 736, 745 n.1 (8th Cir. 1965), *cert. denied,* 382 U.S. 987 (1965).

the amount of stock deemed to be needed—the 6,058 "extra" shares were worth approximately $196,000.[32] It is not known why Gamble-Skogmo did not wait to determine exactly what its obligation was before purchasing any shares.

This decision is admittedly a harsh one, especially since there might have been some coercion to sell due to the anti-trust proceeding against Gamble-Skogmo.[33] However, since *Gamble-Skogmo* did not represent a pure conduit, and because of the formidable difficulties presented by a subjective test for guilt, one must conclude that the mechanical, objective application of section 16(b) here was a proper one.

Gerald William Ostarch

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[32] The 32,000 shares were purchased at $32.35 per share. *Id.* at 738. The 6,058 shares, therefore, cost $195,976.30.

[33] However, in Petteys v. Northwest Airlines, Inc., 246 F. Supp. 526 (D. Minn. 1965), a conversion case, the court found § 16(b) liability without regard to whether the acquisition of stock by the insider was voluntary or involuntary.