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Corporations -- "Profit Realized" In Section 16(b) -- Insider Transactions

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Court follow the lead in *Martin* is yet to be seen. It is hoped that neither the technical requirement of *McNally* that petitioner be released from physical custody, nor the states' discretionary power to deny parole or retry petitioner, will be utilized as a jurisdictional barrier to prevent federal district courts from determining the validity of sentences to be served in the future.

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Corporations—"Profit Realized" In Section 16(b)—Insider Transactions

Gamble-Skogmo, Inc., owner of more than ten per cent of the stock of the plaintiff corporation, bought 32,000 additional shares for a Gamble-Skogmo employees' trust fund.[1] Only 25,942 of those shares were transferred to the fund, however, and the remaining shares were retained by the purchaser. Within six months of this purchase, Gamble-Skogmo sold[2] all of its stock in the plaintiff except that held by the trust fund. Plaintiff sought recovery of Gamble-Skogmo's "profits" on all 32,000 shares under section 16(b) of the Securities Exchange Act of 1934.[3] Only the profit made on the 6,058 retained shares was paid, and plaintiff sued for the profits[4] that would have been realized had the 25,942 shares in the trust fund been included in the short-swing transaction. The district

[1] Gamble-Skogmo was not required to make its contribution to the trust fund in Western Auto stock, or in any other stock for that matter. Western Auto Supply Co. v. Gamble-Skogmo, Inc., 348 F.2d 736, 738 (8th Cir. 1965), *cert. denied*, 382 U.S. 987 (1966).

[2] The sale was pursuant to an antitrust consent decree. United States v. Gamble-Skogmo, Inc., Civil No. 12776, W.D. Mo., July 18, 1960.

[3] 48 Stat. 896 (1934), 15 U.S.C. § 78p(b) (1964). See 44 N.C.L. REV. 835 n.3 (1966) for the full text of the statute. See generally 2 Loss, SECURITIES REGULATIONS 1040-90 (2d ed. 1961); Cole, *Insiders' Liabilities Under the Securities Exchange Act of 1934*, 12 SW. L.J. 147 (1958); Cook & Feldman, *Insider Trading Under the Eecurities Exchange Act* (pts. 1 & 2), 66 HARV. L. REV. 385, 612 (1963); Painter, *The Evolving Role of Section 16(b)*, 62 MICH. L. REV. 649 (1964); Rubin & Feldman, *Statutory Inhibitions Upon Unfair Use of Corporate Information by Insiders*, 95 U. PA. L. REV. 468 (1947). At the time their articles were written, Mr. Cook was Chairman, and Mr. Feldman, Special Council, of the Securities and Exchange Commission, though they did not purport to be speaking on behalf of the Commission.

[4] The profit was calculated at $3.65 per share, a total of $116,800.00, based on the difference between the price per share paid for the 32,000 shares and the price per share received when all 1,262,102 shares were sold. Also, two dividends of $.35 per share, paid on the stock before the short-swing sale, were included.

court held in favor of the defendant,[5] but in *Western Auto Supply Co. v. Gamble-Skogmo, Inc.*[6] the United States Court of Appeals for the Eighth Circuit reversed, holding that the plaintiff should recover profits, realized or not, on all 32,000 shares.

Under section 16(b) liability is based upon an objective measure of proof.[7] A plaintiff need only show that the "insider"[8] traded in his company's stock within a six-month period. A showing of actual unfair use of inside information is not necessary,[9] and the good faith or intention motivating the insider's trading is irrelevant.[10] Since the statute does not prohibit insider trading,[11] it is meant to be broadly construed by the courts so as to have a prophylactic effect.[12] At the same time, section 16(b) makes an insider liable only for "any profit realized"[13] by him on his short-swing transactions. However, neither "profit" nor "realized" is defined in the statute or in the rules issued by the Securities and Exchange Commission. Since in the ordinary violation the "profit realized" is simply the difference between the sale price and the purchase price,

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

[6] 348 F.2d 736 (8th Cir. 1965), *cert. denied,* 382 U.S. 987 (1966). This was a two-to-one decision.

[7] Smolowe v. Delendo Corp., 136 F.2d 231, 235 (2d Cir.), *cert. denied,* 320 U.S. 751 (1943).

[8] An "insider" is a director, officer, or a stockholder owning 10% or more of the stock of the corporation. See Securities Exchange Act of 1934, § 16(a), 48 Stat. 896 (1934), 15 U.S.C. § 78p(a) (1964).

[9] It has been suggested that the preamble of § 16(b), which refers to this, was intended merely as an aid to constitutionality and a guide to the SEC in the exercise of its rule-making authority. Smolowe v. Delendo Corp., 136 F.2d 231, 236 (2d Cir.), *cert. denied,* 320 U.S. 751 (1943). However, while actual motive is irrelevant, the absence of any possibility of improper motive has sometimes been considered relevant by the courts in determining whether a conversion or reclassification of securities involved a "purchase" or "sale." 2 Loss, *op. cit. supra* note 3, at 1041 n.14.

[10] Blau v. Max Factor & Co., 342 F.2d 304, 307 (9th Cir.), *cert denied,* 382 U.S. 892 (1965); B. T. Babbitt, Inc. v. Lachner, 332 F.2d 255, 257 (2d Cir. 1964); Rheem Mfg. Co. v. Rheem, 295 F.2d 473, 475 (9th Cir. 1961); Blau v. Lehman, 286 F.2d 786, 791 (2d Cir. 1960), *aff'd,* 368 U.S. 403 (1962); Walet v. Jefferson Lake Sulphur Co., 202 F.2d 433, 434 (5th Cir.), *cert. denied,* 346 U.S. 820 (1953); Gratz v. Claughton, 187 F.2d 46, 51 (2d Cir.), *cert. denied,* 341 U.S. 920 (1951); Smolowe v. Delendo Corp., *supra* note 9, at 235.

[11] As originally drafted, § 16(b) was to have been a complete prohibition against any insider trading, and criminal penalties were to attach to any of its violations. *Hearings Before Senate Committee on Banking and Currency on S. Res. 84, 56, and 97,* 73d Cong., 1st Sess., pt. 15, at 6430 (1934).

[12] Blau v. Lehman, 368 U.S. 403, 414 (1962).

[13] 48 Stat. 896 (1934), 15 U.S.C. § 78p(b) (1964).

only one court[14] has had occasion thus far to consider what should be the definition of "any profit realized":

> [W]e think it is clear that Congress intended that ordinarily no gain in the value of securities should be deemed to be realized as a profit under the Act until there had been a definitive act by the owner of the securities whereby the paper value of the securities has become a real and includible one . . . .[15]

In *Gamble-Skogmo* there was likewise only a paper profit made on the 25,942 trust fund shares. Consequently it would seem that the court should have affirmed the decision that only the profit admittedly made on the 6,058 shares was recoverable. While those shares were purchased at the same time as the others, they were never transferred to the fund. Instead, they were retained by Gamble-Skogmo and sold along with its earlier-acquired stock less than six months later at a higher price. Although it is not clear in either the opinions or the briefs what the exact relationship of the trust fund to the corporation was, two arguments support the position of this note that no recoverable profit was made on the 25,942 shares.

The Eighth Circuit apparently felt that the trust fund was not enough a separate entity for the corporation to have lost any real control over the shares of stock transferred to the fund.[16] Therefore, it reasoned that because Gamble-Skogmo within a six-month period had purchased a certain number of shares at one price and had sold an equivalent number of shares at a higher price when it disposed of its entire holding, a recoverable profit could be imputed

[14] Heli-Coil Corp. v. Webster, 352 F.2d 156 (3d Cir. 1965), 44 N.C.L. REV. 835 (1966). The term "any profit realized" has been considered indirectly, however, in two cases dealing with an investment banking house's partners who were sitting on the board of directors of the issuing corporations at the time of the partnership's short-swing transactions. In Rattner v. Lehman, 193 F.2d 564 (2d Cir. 1952), the court concluded that the partner was liable only for his distributive share of the profits since "under a literal reading of the statute he cannot be held liable for profits 'realized' by other partners from the firm's short swing transactions." 193 F.2d at 565. In Blau v. Lehman, 368 U.S. 403 (1962), the only Supreme Court case interpreting § 16(b), the Court reached a similar conclusion based on *Rattner*.

[15] 352 F.2d at 167. This definition has been quoted subsequently in Brief for the SEC as Amicus Curiae, p. 19, in Blau v. Lamb, 242 F. Supp. 151 (S.D.N.Y. 1965), now on appeal before the Second Circuit.

[16] The court of appeals, contrary to the district court, held that dividends received on the 25,942 shares in the trust fund were recoverable by plaintiff. 348 F.2d at 744. This might lend strength to the implication that the court of appeals felt that the trust fund was indistinguishable from the corporation.

to the 25,942 shares. The court said that section 16(b) required that purchases and sales be matched arbitrarily so as to disgorge the insider of his maximum profit, regardless of the insider's intent or the time when the stock was purchased.[17] This was based on the widely accepted rule of the leading case of *Smolowe v. Delendo Corp.*[18] There the insiders argued that the sales of the shares involved were made from a backlog of stock they had kept longer than six months. Stressing that the object of the statute was "to squeeze all possible profits out of stock transactions,"[19] the court rejected the insiders' argument[20] that they be allowed to match stock certificates and held that the only rule whereby all possible profits could surely be recovered was that of "lowest price in, highest price out" within six months.[21]

Although the corporation in effect sought to match certificates in opposition to the *Smolowe* rule, the facts of *Gamble-Skogmo* seem sufficiently distinguishable to warrant segregation of shares. Had *Smolowe* permitted matching of certificates, the insiders would have retained measurable profits in violation of the spirit if not the letter of section 16(b). Such a holding would also violate the concept of shares as fungibles.[22] Unlike the insiders in *Smolowe,* Gamble-Skogmo's earlier acquired interest in the plaintiff was not being used as a backlog of stock to evade the statute by speculating in plaintiff's stock. Since the *Smolowe* rule contemplates an arbi-

[17] 348 F.2d at 743.

[18] 136 F.2d 231 (2d Cir.), *cert. denied,* 320 U.S. 751 (1943).

[19] *Id.* at 239.

[20] The insiders argued for the "identity of shares" theory or its corollary, the "first-in, first-out" rule, both borrowed from the tax field. See Treas. Reg. § 1.1012-1(c) (1958), as amended, T.D. 6837, 1965 INT. REV. BULL. No. 31, at 13. They also argued for the striking of an average purchase and sale price, but the court rejected that argument, too, because allowing losses to offset profits would encourage more, not less, insider trading. 136 F.2d at 239. The harshness of the lowest-price-in, highest-price-out rule may be seen by Gratz v. Claughton, 187 F.2d 46 (2d Cir.), *cert. denied,* 341 U.S. 920 (1951), which reasserted the *Smolowe* doctrine after an independent analysis. There the court assessed a judgment of $300,000 against the defendant for his insider "profits," although his trading in the stock had resulted in an actual loss of over $400,000.

[21] The lowest-price-in, highest-price-out test had been specifically included in the original drafts of § 16(b) and deleted without explanation. S. 2693 and H.R. 7852, § 15(b)(1), 73d Cong., 2d Sess. (1934). For an explanation of the way in which the test is meant to be applied, see 2 Loss, *op. cit. supra* note 3, at 1062-66.

[22] Gratz v. Claughton, 187 F.2d 46, 51 (2d Cir.), *cert. denied,* 341 U.S. 920 (1951).

trary matching of purchases and sales, it should not be blindly applied in every case. To apply it here would be to penalize Gamble-Skogmo for a profit as yet unrealized. Until such time as the 25,942 shares in the trust fund are sold, their appreciation, as measured by the difference between what Gamble-Skogmo paid for the stock and what it received from the sale of its other stock, is merely a paper profit. Section 16(b) neither prevents an insider from investing in his company's stock nor penalizes him for using inside information to speculate if the trading is done at six-month intervals.

Furthermore, the court's fear that the policy of section 16(b) would be frustrated by permitting Gamble-Skogmo's defense of segregating shares appears groundless. The statute has not been applied as arbitrarily as the language of the opinions might suggest.[23] For example, conflicting results[24] in applying the term "purchase and sale"[25] to various transactions indicate that most of those decisions have been rendered on an *ad hoc* basis. It has been said that while not doing violence to the supposedly "objective" thrust of the statute, the courts have inferred that Congress did not intend the application of section 16(b) to be purely mechanical and automatic in every respect.[26]

The district court, on the other hand, apparently felt that the trust fund was distinct from the corporation.[27] Thus, at the time Gamble-Skogmo sold all of its interest in the plaintiff, it had no claim to the 25,942 shares, which had already passed into the assets of the trust fund some five months earlier. This would be a distinguishing

[23] See, *e.g.*, Blau v. Max Factor & Co., 342 F.2d 304 (9th Cir.), *cert. denied*, 382 U.S. 892 (1965); Ferraiolo v. Newman, 259 F.2d 342 (6th Cir. 1958), *cert. denied*, 359 U.S. 927 (1959).

[24] *Compare* Walet v. Jefferson Lake Sulphur Co., 202 F.2d 433 (5th Cir.), *cert. denied*, 346 U.S. 820 (1953) (exercise of stock options a "purchase"); Park & Tilford, Inc. v. Schulte, 160 F.2d 984 (2d Cir.), *cert. denied*, 332 U.S. 761 (1947) (conversion of preferred stock into common a "purchase"); Marquette Cement Mfg. Co. v. Andreas, 239 F. Supp. 962 (S.D.N.Y. 1965) (receipt of stock pursuant to corporate liquidation a "purchase"), *with* Roberts v. Eaton, 212 F.2d 82 (2d Cir.), *cert. denied*, 348 U.S. 827 (1954) (receipt of stock in reclassification not a "purchase"); Blau v. Ogsbury, 210 F.2d 426 (2d Cir. 1954) (acquisition of stock under option contract not a "purchase"); Shaw v. Dreyfus, 172 F.2d 140 (2d Cir.), *cert. denied*, 337 U.S. 907 (1949) (receipt of rights distributed to all stockholders proportionately not a "purchase").

[25] 48 Stat. 896 (1934), 15 U.S.C. § 78p(b) (1964).

[26] Painter, *supra* note 3, at 665.

[27] 231 F. Supp. at 461. Letter From Edward J. Callahan, Jr., Counsel for Gamble-Skogmo, Inc., to the writer, April 12, 1966, on file with the *North Carolina Law Review*, states that the trust fund "was a wholly separate entity . . . and no one at Gamble-Skogmo had any position with it nor control over it."

feature from the *Smolowe*-type cases[28] where the insiders still held other stock of the issuer but argued that those shares were of stock acquired more than six months before the sale in question. The "undeniable fact"[29] to the district court was that there was no "purchase" of the stock on Gamble-Skogmo's part. Rather, the corporation had acted simply as a "conduit" through which the shares destined for the trust fund passed.[30] Accordingly, this transfer of stock was not a short-swing transaction. Furthermore, since Gamble-Skogmo delivered the stock to the trust fund at the same price it paid for it,[31] no profit inured to Gamble-Skogmo on the transfer and the whole transaction was the same as if Gamble-Skogmo had made a voluntary gift of the stock to the fund.[32]

While the district court was obviously trying to avoid the "purposeless harshness"[33] of section 16(b), it would have been more

[28] See, *e.g.*, Walet v. Jefferson Lake Sulphur Co., 202 F.2d 433 (5th Cir.), *cert. denied*, 346 U.S. 820 (1953); Gratz v. Claughton, 187 F.2d 46 (2d Cir.), *cert. denied*, 341 U.S. 920 (1951); Blau v. Allen, 163 F. Supp. 702 (S.D.N.Y. 1958).

[29] 231 F. Supp. at 461.

[30] *Ibid.* The district court's argument was accepted by the dissenting judge in the court of appeals. 348 F.2d at 745 (dissenting opinion). Although the SEC argued that the district court's conclusion that Gamble-Skogmo acted as a "conduit" for the purpose of making the purchase for the trust fund "appears to be without support," it conceded that if Gamble-Skogmo had acted "solely as agent for the trust fund, the trial court's result might have been reached without endangering the principles which we feel must not be impaired." Brief for the SEC as Amicus Curiae, p. 13 n.16, Western Auto Supply Co. v. Gamble-Skogmo, Inc., 348 F.2d 736 (8th Cir. 1965), *cert. denied*, 382 U.S. 987 (1966). But, *quaere* whether the abuse of inside information would be any the less in one situation than in the other.

[31] Had Gamble-Skogmo actually sold the 25,942 shares on the market on the day of the transfer, it would have sustained a loss of $.60 per share. Wall Street Journal, Jan. 29, 1960, p. 18, col. 6.

[32] Compare the two so-called "gift" cases cited by the district court, Shaw v. Dreyfus, 172 F.2d 140 (2d Cir.), *cert. denied*, 337 U.S. 907 (1949), and Truncale v. Blumberg, 80 F. Supp. 387 (S.D.N.Y. 1948), where it was held that the making of gifts of warrants or the shares purchased on exercise of the warrants was no violation of § 16(b). The reasoning in both cases was placed on the ground that no profit had been realized by the insiders. In *Truncale* the SEC in its amicus curiae brief specifically argued for the theory that there had been no "profit realized" by the insider, rather than that there had been no "sale." 80 F. Supp. at 391. But, *quaere* whether the making of a gift of appreciated securities is not an economic benefit equal to a profit to the insider, either in terms of taxes, prestige in the community, or recompense for personal services. See Shaw v. Dreyfus, *supra* at 143 (dissenting opinion by Clark, J.). The court of appeals in *Gamble-Skogmo* sought to distinguish these two cases on the basis that they both dealt with bona fide gifts and that neither involved a sale within six months of the gift. 348 F.2d at 743 n.7.

[33] Blau v. Max Factor & Co., 342 F.2d 304, 307 (9th Cir.), *cert. denied*, 382 U.S. 892 (1965).

reasonable if the court had held that the acquisition and transfer of the 25,942 shares were a "purchase" and "sale" by Gamble-Skogmo which resulted in a technical violation of the statute.[34] But, since no profit was realized on the transaction, there was nothing the plaintiff could recover. Again, the only recoverable profit would be on the 6,058 shares that were retained by Gamble-Skogmo and later sold.

It is unfortunate that both of the courts in *Gamble-Skogmo* failed to express clearly their concept of the trust fund's relationship to the corporation. Nevertheless, whether the trust fund be considered separate from or part of the corporation, there seemingly was no "profit realized" by Gamble-Skogmo on the 25,942 trust fund shares. Therefore, it is submitted that a correct application of the statute in this case should have allowed plaintiff to recover only the profit made on the 6,058 shares actually involved in the short-swing transaction.

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Corporations—Section 16(b) Liability—Conversion Transactions by Insiders

In *Heli-Coil Corp. v. Webster*,[1] the United States Court of Appeals for the Third Circuit has taken a novel approach to certain questions concerning liability under the Securities Exchange Act of 1934.[2] Defendant Webster, a director of Heli-Coil Corporation, purchased a quantity of the corporation's callable debentures, which were convertible into common stock any time before redemption or maturity. Within six months of the purchase of the debentures, Webster converted, exchanging the bonds for 3,600 shares of common stock, and within six months of conversion, he sold 1,300 shares of the Heli-Coil common. There had been no call on the debentures. The corporation brought suit to recover short-swing profits under the provisions of section 16(b) of the Securities Exchange Act.[3] The district court held that the conversion of the

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

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[1] 352 F.2d 156 (3d Cir. 1965).

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

[3] (b) For the purpose of preventing the unfair use of information which may have been obtained by such beneficial owner, director, or