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# Section 16 (b) a New Trend in Regulating Insider Trading

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## SECTION 16(b): A NEW TREND IN REGULATING INSIDER TRADING

*Lewis D. Lowenfels*†

One of the more widely publicized and litigated provisions of the federal securities laws is section 16(b)<sup>1</sup> of the Securities Exchange Act of 1934.<sup>2</sup> Enacted for the express purpose of preventing the unfair use of confidential corporate information by insiders, section 16(b) 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.<sup>3</sup>

This article elucidates and analyzes a striking development of recent judicial interpretations and applications of this section. The federal judiciary within the last few years has shifted from a strict and comparatively harsh objective interpretation of the section to a much

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<sup>1</sup> 15 U.S.C. § 78p(b) (1964).

<sup>2</sup> 15 U.S.C. §§ 78a-78jj (1964).

<sup>3</sup> 48 Stat. 896 (1934), 15 U.S.C. § 78p(b) (1964).

more subjective approach, an analysis less concerned with the narrow letter of the law than with the particular facts at bar—in short, an approach less automatic and mechanistic and more fact-oriented and pragmatic.<sup>4</sup> Whether or not this new subjective approach has any support in the statute and its legislative history and the policy considerations both for and against this new subjective approach are examined. Finally, the new trend is analyzed in the larger context and perspective of the growth of implied liabilities under other provisions of the federal securities laws and of recent developments under state law.

## I

## THE TRADITIONAL APPROACH

For over thirty years the great majority of decisions on both the federal district court and appellate levels followed the “crude rule-of-thumb—objective approach” in interpreting and applying section 16(b).<sup>5</sup> The crucial issue in each of these cases was whether or not the defendant had purchased and sold the securities in question for a profit within a six month period. If such actions had been consummated, then the defendant was held liable. A particularly harsh method of computing the magnitude of liability—by matching defendant’s highest sales against his lowest purchases—added to the severity of section 16(b)’s impact.<sup>6</sup> Very little subjective reasoning was attempted in

<sup>4</sup> See Painter, *The Evolving Role of Section 16(b)*, 62 MICH. L. REV. 649 (1964).

<sup>5</sup> The two leading cases illustrating this approach are discussed in detail below. They are *Park & Tilford, Inc. v. Schulte*, 160 F.2d 984 (2d Cir.), cert. denied, 332 U.S. 761 (1947); *Smolowe v. Delendo Corp.*, 136 F.2d 231 (2d Cir.), cert. denied, 320 U.S. 751 (1943).

<sup>6</sup> For a full discussion with respect to the computation of liability under § 16(b), see Cook & Feldman, *Insider Trading Under the Securities Exchange Act* (parts 1 & 2), 66 HARV. L. REV. 385, 612 (1953). The application of the “highest sales matched against the lowest purchases” method of computation can best be appreciated by a hypothetical illustration. Assume that an insider enters into the following transactions, which are grouped together for simplicity of analysis:

- |     |         |       |                   |
|-----|---------|-------|-------------------|
| (1) | 4/ 1/63 | Buys  | 100 shares at 120 |
| (2) | 5/15/63 | Buys  | 100 shares at 90  |
| (3) | 5/18/63 | Sells | 100 shares at 93  |
| (4) | 5/21/63 | Buys  | 100 shares at 96  |
| (5) | 5/23/63 | Sells | 100 shares at 98  |
| (6) | 5/26/63 | Buys  | 100 shares at 110 |
| (7) | 5/29/63 | Sells | 100 shares at 113 |
| (8) | 8/10/63 | Sells | 100 shares at 120 |

A businessman examining this sequence of transactions would probably conclude that the insider made a profit of \$300 on transactions (2) and (3), \$200 on (4) and (5), \$300 on (6) and (7), and \$0 on (1) and (8), closing the account, for a total trading profit of \$800. However, by matching lowest price in with highest price out, the following tabulation is made:

any of these cases. For example, it made little difference whether or not the defendant in question had actually used inside information to his own advantage. Moreover, it was seldom asked whether or not the transaction in question could possibly lend itself to the type of speculative activity that the statute was designed to prevent. The fact that defendant's purchase or sale was entirely involuntary, or that the purchases and sales were between entities controlled by the same interests without the slightest opportunity for speculative profit, made little difference.

Two early decisions by the Second Circuit, *Smolowe v. Delendo Corp.*<sup>7</sup> and *Park & Tilford, Inc. v. Schulte*,<sup>8</sup> stood as twin authorities for implementing this objective approach. In *Smolowe*, minority stockholders of the Delendo Corporation sued two directors and officers of that corporation for profits realized from purchases and sales of Delendo common stock within a six month period. Plaintiffs conceded that defendants had acted in good faith and without any unfair use of inside information, but nonetheless contended that section 16(b) required them to disgorge any profits realized from their trading activities. The district court sustained plaintiffs' position<sup>9</sup> and the Second Circuit affirmed.<sup>10</sup> In an opinion which was to have far-reaching implications, Judge Clark stated:

It is apparent . . . from the language of § 16(b) itself, as well as from the Congressional hearings, that the only remedy which its framers deemed effective for this reform was the imposition of a liability based upon an objective measure of proof. . . .

A subjective standard of proof, requiring a showing of an actual unfair use of inside information, would render senseless the provisions of the legislation limiting the liability period to six months, making an intention to profit during that period immaterial, and exempting transactions wherein there is a bona fide acquisition of stock in connection with a previously contracted debt. . . . its total effect would be to render the statute little more of an incentive to insiders to refrain from profiteering at the expense of the outside stockholder than are the common-law

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Purchases	Sales	Profit
100 at 90 (trans. (2))	100 at 120 (trans. (8))	3,000
100 at 96 (trans. (4))	100 at 113 (trans. (7))	1,700
100 at 110 (trans. (6))	100 at 98 (trans. (5))	0

Thus appears a total § 16(b) profit of \$4,700. In this computation all transactions which yield losses are to be ignored.

<sup>7</sup> 136 F.2d 231 (2d Cir.), cert. denied, 320 U.S. 751 (1943).

<sup>8</sup> 160 F.2d 984 (2d Cir.), cert. denied, 332 U.S. 761 (1947).

<sup>9</sup> 46 F. Supp. 758 (S.D.N.Y. 1942).

<sup>10</sup> 136 F.2d 231 (2d Cir. 1943).

rules of liability; it would impose a more stringent statute of limitation upon the party aggrieved at the same time that it allowed the wrongdoer to share in the spoils of recovery.<sup>11</sup>

The decision in *Smolowe* was justified by that particular factual setting. Defendants did have inside information with respect to an advantageous tax settlement and a possible merger and, although no abuse of inside information was alleged, it was clear that defendants' activity could have lent itself to the types of abuses that the statute was designed to prevent. The unfortunate aspect of the *Smolowe* opinion is that it was the first major interpretive decision under section 16(b), and its sweeping language was to have harsh effects when applied indiscriminately to completely different sets of facts in the future. Moreover, it was the *Smolowe* court which introduced the "highest sales matched against the lowest purchases" measure of damages,<sup>12</sup> a standard that was to prove too severe even for some later courts wearied in the tradition of a harsh, objective approach.<sup>13</sup>

In *Park & Tilford, Inc. v. Schulte*,<sup>14</sup> defendants, controlling shareholders of Park & Tilford, Inc., were trustees of a trust owning Park & Tilford preferred stock. This preferred stock was redeemable at fifty-five dollars per share and convertible into Park & Tilford common stock in the ratio of 1 $\frac{1}{4}$  shares of common for each share of preferred. After a spectacular rise in the price of the common, probably because of a rumor of an impending dividend to be paid in liquor, the corporation served notice of redemption of its preferred stock. Within a month defendants converted their preferred, valued at 364,871 dollars, into common, valued at 480,853 dollars, and within six months thereafter sold the common for 782,999 dollars. Plaintiff thereupon sued under section 16(b) to recover the profits realized by defendants. The district court held for plaintiff, awarding 302,145 dollars in damages, and the defendants immediately appealed.<sup>15</sup>

The Court of Appeals for the Second Circuit disposed of the first issue—whether or not the conversion was a purchase of the common stock—in short order.

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 . . . . Not otherwise could the Act accomplish the Congressional pur-

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<sup>11</sup> *Id.* at 235-36 (footnote omitted).

<sup>12</sup> See note 6 *supra*.

<sup>13</sup> See pp. 52-53 *infra*.

<sup>14</sup> 160 F.2d 984 (2d Cir. 1947).

<sup>15</sup> See *id.*, at 987.

pose to protect the outside stockholders against at least shortswing speculation by insiders with advance information.<sup>16</sup>

The court then faced the issue of damages—specifically whether or not the purchase price upon conversion was the 364,871 dollar value of the preferred or the higher 480,853 dollar value of the common. Choosing to follow the path which would “squeeze all possible profits out of stock transactions, and . . . establish a standard so high as to prevent any conflict between the selfish interest of a fiduciary . . . and the faithful performance of his duty,”<sup>17</sup> the court opted for the lower figure and thus increased the damages awarded to 418,128 dollars.

As in *Smolowe*, the decision in *Park & Tilford* was justified by the facts at bar. The problem, however, was the sweeping nature of the holding. Defendants had argued that their conversion was forced by the corporation’s call for redemption and thus was an involuntary act falling outside the ambit of section 16(b). The court of appeals labeled this contention “somewhat absurd,”<sup>18</sup> as indeed it was, in light of the fact that defendants controlled the corporation and thus could have prevented the passage of the redemption resolution or rescinded it after passage. Unfortunately, later decisions were not so discriminating. Situations where defendants were genuinely forced into involuntary conversions were not always held to fall outside the sweep of the holding in *Park & Tilford*.<sup>19</sup>

It is beyond the purpose and scope of this article to trace the growth and development of the objective interpretation of section 16(b). The progeny of *Smolowe* and *Park & Tilford* have been fully analyzed by other commentators.<sup>20</sup> It suffices to say that the great ma-

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<sup>16</sup> *Id.*

<sup>17</sup> *Id.* at 988, quoting *Smolowe v. Delendo Corp.*, 136 F.2d 231, 239 (2d Cir. 1943).

<sup>18</sup> *Id.*

<sup>19</sup> See, e.g., *Petteys v. Northwest Airlines*, 246 F. Supp. 526 (D. Minn. 1965), which fortunately was reversed on appeal *sub nom.* *Petteys v. Butler*, 367 F.2d 528 (8th Cir. 1966). See p. 54 *infra*. See also *Heli-Coil Corp. v. Webster*, 222 F. Supp. 831 (D.N.J. 1963), *aff'd in part on other grounds*, 352 F.2d 156 (3d Cir. 1965). Here defendant was “requested” to convert his debentures because the conversion would materially improve the appearance of the company’s financial statement. Many situations of genuine involuntary conversions engendering problems for insiders remain unreported because they never reach the stage of litigation. The “offending” insider is merely informed of his transgression, usually after a letter is received by the corporation from one of the lawyers specializing in § 16(b) cases, and restitution is promptly made by the insider to the corporation.

<sup>20</sup> The principal law review articles dealing with § 16(b) are: Cole, *Insiders' Liabilities Under the Securities Exchange Act of 1934*, 12 Sw. L.J. 147 (1958); Cook & Feldman, *Insider Trading Under the Securities Exchange Act* (parts 1 & 2), 66 HARV. L. REV. 385, 612 (1953); Hamilton, *Convertible Securities and Section 16(b): The End of An Era*, 44 TEXAS L. REV. 1447 (1966); Laufer, *Effect of Section 16(b) of the Securities Exchange Act*

majority of 16(b) decisions between 1934 and 1964 regarded the harsh, "no excuses taken" approach as absolutely vital to protect the investing public against insider abuses. Occasional aberrations appeared in the form of isolated opinions adopting a more subjective approach. For example, Judge (now Mr. Justice) Potter Stewart refused to apply the holding in *Park & Tilford* to a situation involving a genuinely involuntary conversion without any possibility of speculative, insider abuse.<sup>21</sup> And the Second Circuit refused the application of a "black-letter rubric" to a reclassification situation that affected all shareholders equally and granted no speculative advantages to the defendants.<sup>22</sup> Such opinions, however, were rare, and until very recently, the great weight of authority adhered to the principles of *Smolowe* and *Park & Tilford*.

## II

### THE NEW TREND

#### A. *The Appellate Level*

The last four years have witnessed an abrupt shift in the trend of judicial interpretation under section 16(b). The approach elucidated in the preceding section has been tempered by a more subjective approach, an analysis more concerned with whether or not defendant's conduct in a specific factual setting could possibly lend itself to the types of abuses that the statute was designed to prevent. The first case to illustrate this approach on the appellate level was *Blau v. Max Factor & Company*.<sup>23</sup>

Max Factor & Company had two classes of stock—class A stock, which was publicly held, and common stock, which was held by certain insiders. These two classes of stock were identical in all respects

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*on Use of Options by Insiders*, 8 N.Y.L.F. 232 (1962); Meeker & Cooney, *The Problem of Definition in Determining Insider Liabilities Under Section 16(b)*, 45 VA. L. REV. 949 (1959); 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); Comment, *Securities Regulation: Insider Status in Legal Fiction and Financial Fact—A Proposed Revision to Section 16(b)*, 50 CALIF. L. REV. 500 (1962); Comment, *Convertible Securities and Section 16(b): The Persistent Problems of Purchase, Sale and Debts Previously Contracted*, 64 MICH. L. REV. 474 (1966); Comment, *The Scope of "Purchase and Sale" Under Section 16(b) of the Exchange Act*, 59 YALE L.J. 510 (1950). See also Conant, *Duties of Disclosure of Corporate Insiders Who Purchase Shares*, 46 CORNELL L.Q. 53 (1960); Painter, *Section 16(b) of the Securities Exchange Act: Legislative Compromise or Loophole*, 113 U. PA. L. REV. 358 (1965).

<sup>21</sup> *Ferraiolo v. Newman*, 259 F.2d 342 (6th Cir. 1958), cert. denied, 359 U.S. 927 (1959).

<sup>22</sup> *Roberts v. Eaton*, 212 F.2d 82 (2d Cir.), cert. denied, 348 U.S. 827 (1954).

<sup>23</sup> 342 F.2d 304 (9th Cir.), cert. denied, 382 U.S. 892 (1965).

except that the board of directors was empowered to declare lesser dividends on the common than on the class A stock. The two classes had been created to permit the payment of maximum dividends to the public stockholders while retaining earnings otherwise payable to the insiders for use in the business without exposing the insiders to potential tax liability. Under the corporation's charter, common stock was exchangeable for class A stock, share for share, at any time. In contemplation of selling a portion of their holdings to the public, the insiders exchanged 200,000 shares of common stock for an equal number of class A shares and within one month sold the latter shares to the public. Plaintiff sued to recover "profits" which allegedly resulted from an increase in the market price of the class A between the date of the exchange and the date of sale. The Ninth Circuit refused to see the exchange of common for class A as a purchase of class A within the meaning of section 16(b) and dismissed plaintiff's complaint.<sup>24</sup> The court's opinion distinguished the decision in *Park & Tilford*.<sup>25</sup> The rationale behind the holding in *Max Factor* was stated as follows:

Appellees' investment commitment in Max Factor & Co. was a long-term one, undertaken, as we have noted, many years prior to their exchange of Common for Class A. The exchange of Class A for Common did not interrupt the continuity of appellees' investment: it did not increase or decrease the amount invested, or alter in any way the risk assumed long years before. Moreover, since there was no speculative advantage in holding Class A rather than Common, the exchange conferred no opportunity for speculative profit which appellees did not already enjoy. . . .

Thus, the making of the exchange, and its timing, were simply irrelevant to the use of insider information in short-term speculation—the problem with which section 16(b) is concerned.<sup>26</sup>

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<sup>24</sup> *Id.*

<sup>25</sup> *Id.* at 309.

<sup>26</sup> *Id.* at 308-09. The adoption of rule 16b-9, 17 C.F.R. § 240.16b-9, by the SEC on February 17, 1966 appears to alter substantially the rules in the conversion area. It remains to be seen what kind of a reception the courts will afford rule 16b-9, which reads as follows:

(a) Any acquisition or disposition of an equity security involved in the conversion of an equity security which, by its terms or pursuant to the terms of the corporate charter or other governing instruments, is convertible immediately or after a stated period of time into another equity security of the same issuer, shall be exempt from the operation of section 16(b) of the Act: *Provided, however,* That this section shall not apply to the extent that there shall have been either (1) a purchase of any equity security of the class convertible (including any acquisition of or change in a conversion privilege) and a sale of any equity security of the class issuable upon conversion, or (2) a sale of any equity security of the class convertible and any purchase of any equity security issuable upon conversion (otherwise than in a transaction involved in such conversion or in a



The next decision illustrating the new trend was *Heli-Coil Corp. v. Webster*.<sup>27</sup> Defendant, a director of Heli-Coil Corp., purchased convertible debentures in that corporation on November 20, 1958, converted the debentures into underlying common stock on March 18, 1959, and within six months sold the underlying common. Plaintiff claimed that the conversion of the debentures into the underlying common stock was a sale of the debentures and a purchase of the common within the meaning of section 16(b), and therefore defendant should be liable for the 71,400 dollar increase in the value of the debentures between November 20, 1958 and March 18, 1959 and for the 45,144 dollar increase in the value of the common between March 18, 1959 and the date of its sale. The district court sustained plaintiff's position,<sup>28</sup> but the Third Circuit reversed in part. Adhering to the position enunciated by the Securities and Exchange Commission in its amicus brief, the court of appeals held that the conversion of the debentures was indeed a sale of the debentures and a purchase of the underlying common stock, but that no profit had been realized by the defendant at the time of this conversion. A profit was realized by defendant only when the underlying common stock was sold for cash. Thus, plaintiff's recovery was limited to the 45,144 dollar increase in the value of the common stock between March 18, 1959 and the date of its sale. The court spoke in terms of an "objective test" and a "crude rule-of-thumb" and purported to follow the authority of *Park & Tilford*.<sup>29</sup> But the decision itself, as the dissenters pointed out, was really an illogical compromise between the district court's opinion, which carried the "crude rule-of-thumb" approach to its logical conclusion and awarded plaintiff the full 116,544 dollars, and the holding in *Blau v. Max Factor & Co.*, which would absolve the plaintiff from all liability on the theory that the conversion of the debentures was neither a sale of the debentures nor a purchase of the underlying common stock.

Nine months after the holding in *Heli-Coil*, the Second Circuit

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transaction exempted by any other rule under section 16(b)) within a period of less than 6 months which includes the date of conversion.

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

(c) For the purpose of this section, an equity security shall be deemed convertible if it is convertible at the option of the holder or of some other person or by operation of the terms of the security or the governing instruments.

<sup>27</sup> 352 F.2d 156 (3d Cir. 1965).

<sup>28</sup> 222 F. Supp. 831 (D.N.J. 1963).

<sup>29</sup> 352 F.2d at 165-67.

moved to follow the trend initiated by *Max Factor*. In *Blau v. Lamb*,<sup>30</sup> Edward Lamb, an officer and director of Air-Way Industries, and Edward Lamb Enterprises, a family corporation wholly owned by the Lambs, had received convertible preferred stock of Air-Way pursuant to a merger between Air-Way and Lamb Industries, a private corporation ninety-seven per cent owned by Lamb and his family. Within six months after receiving the Air-Way convertible preferred stock, Edward Lamb and Edward Lamb Enterprises converted these securities into Air-Way common stock as part of a preconceived plan to increase Lamb's voting control of Air-Way. Plaintiff claimed that these conversions were sales of the preferred stock which must be matched against the earlier purchases of the preferred under section 16(b), and, therefore, Air-Way was entitled to a 1,138,732 dollar recovery from Edward Lamb. The district court held for plaintiff stating, "It requires little imagination to infer . . . a corporate milieu rife with opportunities for speculation and misuse of inside information."<sup>31</sup> The Second Circuit reversed, emphasizing the judicial obligation to apply reason to each individual fact situation. Even assuming that the conversion had been prompted by Lamb's desire to increase his control of Air-Way, the court of appeals emphasized that the economic equivalence of the convertible preferred stock and the common stock, combined with the unchanged investment position of Edward Lamb and Edward Lamb Enterprises, insured that the "conversion afforded the insiders no opportunity to realize a gain by speculative trading in Air-Way Preferred."<sup>32</sup> For this reason, the court held that the conversion was not a section 16(b) sale of the preferred.

The court of appeals in *Blau v. Lamb* was obliged by the facts of that case to carry its subjective reasoning beyond the conversion area. Plaintiff had claimed that certain transfers of Air-Way common stock between Edward Lamb Enterprises and Lamb Industries within a six month period engendered profits recoverable under section 16(b). The court of appeals concluded:

By virtue of Lamb's pervasive control over Industries and Enterprises, there was at most a token change in the insider's investment position when Air-Way Common was transferred from Industries to Enterprises; Lamb indirectly owned this stock both before and after its transfer. Thus Lamb did not place himself where he could make any more advantageous use of inside information for speculative purposes that he could have before the

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<sup>30</sup> 363 F.2d 507 (2d Cir. 1966), cert. denied, 385 U.S. 1902 (1967).

<sup>31</sup> 242 F. Supp. 151, 157 (S.D.N.Y. 1965).

<sup>32</sup> 363 F.2d at 522.

transfer. Nor did the decision to transfer the Air-Way Common alter the nature of his investment, increase or decrease the amount invested, or alter in any way the risks involved.<sup>33</sup>

Further, the court of appeals rejected the district court's argument that all transfers between corporate pocketbooks less than one hundred per cent owned should be subjected to section 16(b) liability, because no precise criteria exist to enable courts to know how much control less than one hundred per cent is enough to invoke the statute.

A scant three months after the decision in *Blau v. Lamb*, the Eighth Circuit adopted the subjective approach in *Petteys v. Butler*.<sup>34</sup> In *Petteys*, two directors and minority stockholders of Northwest Airlines converted their holdings of preferred stock into common stock pursuant to a call for redemption of the preferred, and within six months sold the common at substantially increased prices. Plaintiff claimed that the conversion was a purchase of the common which section 16(b) required to be matched against the later sales of the common and that defendants were liable for the profits realized. The district court sustained plaintiff's position,<sup>35</sup> but the court of appeals reversed. Emphasizing that "each case must be examined on its own facts and the Act only applied when these facts disclose the possibility of abuses that the Act [was] designed to prevent,"<sup>36</sup> the court found that the defendants' actions could not possibly have resulted in insider speculation:

The preferred stock held by the two directors was fully marketable and listed on the New York Exchange. It was protected against dilution, had equal voting power, was fully convertible and at all times maintained a market value equivalent to the common. The conversion did not increase or decrease the amount invested, change the proportion of ownership, affect voting rights, or substantially alter the risk assumed. *Blau v. Max Factor supra*. Thus, it appears to us that the common and preferred are truly "economic equivalents" in which speculation from their conversion would be virtually impossible.<sup>37</sup>

The most recent decision on the appellate level adopting the subjective approach carried the new trend beyond previous authorities. In *Chemical Fund, Inc. v. Xerox Corp.*,<sup>38</sup> Chemical Fund became the owner of more than ten per cent of Xerox's 41½ per cent convertible

<sup>33</sup> *Id.* at 526.

<sup>34</sup> 367 F.2d 528 (8th Cir. 1966), *cert. denied*, 385 U.S. 1006 (1967), *aff'g* *Petteys v. Northwest Airlines, Inc.*, 246 F. Supp. 526 (D. Minn. 1965).

<sup>35</sup> 246 F. Supp. 526 (D. Minn. 1965).

<sup>36</sup> 367 F.2d at 533.

<sup>37</sup> *Id.* at 537.

<sup>38</sup> 377 F.2d 107 (2d Cir. 1967).

subordinated debentures in December of 1962 and, for the following eleven months, continued to hold more than ten per cent of this class of securities. During this eleven month period the Fund continuously sold Xerox common and purchased convertible debentures in an effort to increase the yield from its investment in Xerox. The case arose when Chemical Fund sought a declaratory judgment absolving it from any liability to Xerox under section 16(b) and Xerox counterclaimed seeking judgment for 153,972 dollars. The district court applied section 16(b) in the orthodox, mechanical fashion, matched the lowest purchases of debentures against the highest sales of the "equivalent" common, and held for plaintiff.<sup>39</sup> The court of appeals unequivocally reversed. In an opinion which not only overturned the court below, but also specifically disregarded the position taken in the amicus brief submitted by the Securities and Exchange Commission, the court of appeals held that the debentures were not a class of equity securities by themselves and that the total percentage of Xerox common that a debenture holder would own following a hypothetical conversion of his debentures was the relevant percentage for testing whether the defendant was a more than ten per cent holder under section 16(b). Since the Fund would only own 2.7 per cent of Xerox common under this test, it was absolved from liability. The court went to particular lengths to justify its decision on the ground that bondholders do not have the same access to inside information as officers, directors and ten per cent stockholders.

The court's emphasis upon reason is refreshing in an area marked chiefly by mechanical decisions. Moreover, the court's reluctance to penalize public investors in a mutual fund for management's inadvertent and comparatively technical violations of the Securities Exchange Act is commendable. The decision, however, did not face the problem that defendant's conduct could have lent itself to the types of abuses that 16(b) was designed to prevent. The fund had one of its own directors on the Xerox board of directors, thus granting it easy entry to inside information which could have proven valuable in connection with its trading activities. Also, the court's statutory argument was weak. Section 16(a) provides for recovery from a "beneficial owner of more than 10 per centum of any class of any equity security"<sup>40</sup> and under section 3(a)(11) it is clear that a debenture convertible into an equity security is an equity security.<sup>41</sup> In the last analysis, however, the court of appeals probably reached the preferable result on the fact pat-

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<sup>39</sup> See *id.* at 108-09.

<sup>40</sup> 48 Stat. 896 (1934), 15 U.S.C. § 78p(a) (1964).

<sup>41</sup> Securities Exchange Act of 1934 § 3(a)(11), 15 U.S.C. § 78c(a)(11) (1964).

tern presented by this particular case, and, in the event an abuse of inside information arises in a similar factual setting in the future, the court will have ample weapons with which to fashion an appropriate remedy.<sup>42</sup>

### B. *The District Courts*

Four of the five decisions summarized above represent reversals by several federal appellate courts of district court decisions. It is clear from these cases that courts of appeals are leading the way toward a more rational, subjective interpretation of section 16(b). There is recent evidence, however, that the federal district courts are beginning to sense this new trend and to follow it.

In *Feder v. Martin Marietta Corp.*,<sup>43</sup> plaintiff, a shareholder of Sperry Rand Corporation, sought recovery, on behalf of Sperry Rand, of profits realized by defendant Martin Marietta from alleged purchases and sales of Sperry common stock within a six month period. The crucial issue was whether or not Martin was a director of Sperry within the meaning of section 16(b), and this in turn depended upon whether the chief executive officer of Martin, who was also a director of Sperry, had been deputized by defendant to represent its interests on the Sperry board.<sup>44</sup> The court rejected any litmus paper test in reaching its decision, preferring to examine the peculiar factual circumstances of the situation before it with meticulous care. The court found that it was Sperry's initiative that caused the Martin officer to join its board, not any affirmative action on the part of defendant. The court further found that the officer's personal interest, not the desire to represent Martin's investment interests, was the primary motivation for his acceptance of the Sperry directorship. In addition, the officer involved neither disclosed inside information relevant to Sperry investment matters nor reported what transpired at Sperry's board meetings to Martin. Finally, the court found that no instructions were given by Martin as to what positions the officer was to take on Sperry matters. Thus, the district court held that Martin did not deputize the officer to represent its interests on the Sperry board and dismissed plaintiff's complaint. The crucial element to be gleaned from this case is not so much the holding, which depends upon how one chooses to read the conflicting evidence, but rather the process of reasoning in reach-

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<sup>42</sup> See pp. 61-64 *infra*.

<sup>43</sup> 1968 CGH FED. SEC. L. REP. ¶ 92,140 (S.D.N.Y. 1968).

<sup>44</sup> For other cases which have considered this problem, see *Blau v. Lehman*, 286 F.2d 736 (2d Cir. 1960), *aff'd*, 368 U.S. 403 (1962); *Rattner v. Lehman*, 193 F.2d 564 (2d Cir. 1952).

ing the decision—the avoidance of a mechanical standard and the willingness to focus upon the peculiar facts of this particular case in seeking the path to a reasoned conclusion.

Another example of the new trend on the district court level is *Lynman v. Livingston*.<sup>45</sup> In this case, defendant Livingston purchased convertible debentures in 1962, converted these debentures into common stock in December, 1964, and, on February 22, 1965, sold the common stock received upon conversion. Plaintiff claimed that the conversion of the debentures represented a purchase of the common which had to be matched against the later sales of the common under section 16(b). The district court disagreed, refused to view the conversion as a purchase of the common, and entered summary judgment for defendant. The crux of the court's reasoning was based on the fact that the corporation had called its debentures for redemption on January 6, 1965. Thus defendant's conversion was entirely involuntary as a practical matter. If he failed to convert, he would have been compelled to accept 1,057 dollars for each 1,000 dollar debenture. If he sold his debentures on the open market, he would have realized 1,938 dollars per debenture, but would have been obliged to pay substantial taxes. Only by conversion could the defendant realize the full 1,938 dollar market value per debenture and at the same time avoid taxes. Thus "the conversion which Livingston effected was compelled as a matter of economic necessity."<sup>46</sup> The court went on to distinguish *Park & Tilford* and to conclude that the transaction in question "was not one that could have lent itself to the practices which section 16(b) was enacted to prevent."<sup>47</sup>

### III

#### THE CRITIQUE

The new trend toward a more subjective approach in applying section 16(b) finds substantial support in the statute, the legislative history, and contemporary developments under both the federal securities laws and state common law.

##### A. *The Statute*

Three principal arguments based upon the words of section 16(b) may be advanced to support the subjective approach. First, the initial

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<sup>45</sup> 276 F. Supp. 104 (D. Del. 1967).

<sup>46</sup> *Id.* at 106.

<sup>47</sup> *Id.* at 107, quoting *Ferraiolo v. Newman*, 259 F.2d 342, 346 (6th Cir. 1958):

clause of section 16(b) describes its purpose as “. . . 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 . . . .” This is not objective, mechanistic language. A policy and a purpose—to prevent the unfair use of inside information for speculative profit by officers, directors, and more than ten per cent shareholders—is clearly set out, and the remaining provisions of section 16(b) are designed to implement this policy and purpose. Where the courts find that no possibility of this type of abuse exists, the statute has no application. Second, section 16(b) authorizes the recovery of any profits realized by an insider trading within a period of six months “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.”<sup>48</sup> A number of courts, adhering to the traditional, objective approach, have read this language as though it required the insider to be held liable for profits realized in a six month period “irrespective of any possibility of unfair use of inside information.” In light of the statutory language used, such an interpretation seems unduly harsh. The courts have no right to ask whether or not the insider initially intended to consummate a six month trade; this is expressly foreclosed by the statute. On the other hand, the courts would seem to have every right to ask whether or not the facts at bar could possibly lend themselves to the types of abuses that 16(b) was intended to prevent. Indeed, this type of an inquiry would seem to be mandated by the initial clause of section 16(b) quoted above. Finally, the Securities and Exchange Commission is empowered to exempt by regulation any transactions “not comprehended within the purpose of this subsection.”<sup>49</sup> It would seem that Congress realized that section 16(b) could become purposelessly harsh if applied too objectively and thus added a safety valve in the form of an administrative exemptive power. Such agency rule-making, however, is typically limited to exempting broad categories of transactions, as the rules promulgated under section 16(b) illustrate.<sup>50</sup> Thus, if the congressional purpose is to be properly implemented, it remains for the federal courts to temper the possible injustices of section 16(b) via a flexible and pragmatic case by case analysis.

It is difficult to make a convincing case for the objective approach

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<sup>48</sup> 48 Stat. 896 (1934), 15 U.S.C. § 78p(b) (1964).

<sup>49</sup> *Id.*

<sup>50</sup> 17 C.F.R. § 240.16b-1 to 16b-10 (1968).

under the language of section 16(b). One could argue that the initial clause is merely intended to be introductory, an aid to constitutionality, and thus should be accorded little weight in militating toward a subjective approach.<sup>51</sup> Also, the phrase "irrespective of any intention on the part of such beneficial owner, director, or officer in entering into such transaction"<sup>52</sup> may express a congressional preference for an objective approach, no matter what qualifying words follow this phrase. Finally, it might be contended that Congress's grant of exemptive power to the Securities and Exchange Commission was the sole safety valve intended for a rigid, inflexible statute; thus, the federal courts have neither mandate nor right to create exemptions on a case by case basis. Each of these arguments, however, is an unnatural, overly-technical view of the statute. Indeed, in light of the statutory language, it is hard to see why the federal courts adhered to the objective approach for so long a period.

### B. *The Legislative History*

The legislative history lends further support to the conclusions drawn from an analysis of the words of section 16(b). The prevention of the unfair use of inside information to secure short term trading profits by corporate directors, officers and substantial shareholders is constantly reiterated as the central purpose underlying this statutory provision. The Report of the Senate Committee on Banking and Currency states unequivocally:

The bill further aims to protect the interests of the public by preventing directors, officers, and principal stockholders of a corporation, the stock of which is traded in on exchanges, from speculating in the stock on the basis of information not available to others. Any change in the holdings of such insiders must be reported to the Commission, and profits realized from the purchase and sale, or the sale and purchase of an equity security within a period of less than 6 months are recoverable by the corporation. Such a provision will render difficult or impossible the kind of transactions which were frequently described to the committee, where directors and large stockholders participated in pools trading in the stock of their own companies, with the benefit of advance information regarding an increase or resumption of dividends in some cases, and the passing of dividends in others.<sup>53</sup>

In addition, extensive hearings were held before congressional com-

<sup>51</sup> This argument was set forth with approval in *Smolowe v. Delendo Corp.*, 136 F.2d 231, 236 (2d Cir. 1943).

<sup>52</sup> 48 Stat. 896 (1934), 15 U.S.C. § 78p(b) (1964).

<sup>53</sup> S. REP. No. 792, 73d Cong., 2d Sess. 9 (1934).



Court's view that 10b-5 protects the whole community of corporate interests—creditors as well as stockholders.<sup>192</sup>

The Third,<sup>193</sup> Fifth,<sup>194</sup> and Seventh<sup>195</sup> Circuits have adopted their own "new fraud" approaches which are broader than *Schoenbaum*.<sup>196</sup> Some Third and Seventh Circuit cases can be read as imposing liability on directors for mismanagement in corporate securities dealings with anyone.<sup>197</sup> And the Fifth Circuit would extend the 10b-5 net at least to transactions with officers, directors, and "others in league with them or the one controlling them."<sup>198</sup> The

<sup>192</sup> See *Superintendent of Ins. v. Bankers, Life & Cas. Co.*, 404 U.S. 6, 12 (1971). This is particularly true when creditors are injured although stockholders receive full information.

<sup>193</sup> *Pappas v. Moss*, 393 F.2d 865, 869-70 (3d Cir. 1968).

<sup>194</sup> *Shell v. Hensley*, 430 F.2d 819, 826-27 (5th Cir. 1970) (sale of control); *Herpich v. Wallace*, 430 F.2d 792, 811 (5th Cir. 1970) (purchase of assets at excessive price); *Rekant v. Desser*, 425 F.2d 872, 881-82 (5th Cir. 1970) (sale of securities for inadequate consideration).

<sup>195</sup> *Swanson v. American Consumer Indus., Inc.*, 415 F.2d 1326, 1333-34 (7th Cir. 1969) (derivative action proper when "directors in position of conflicting interest or loyalty" and know of unfairness to corporation); *Dasho v. Susquehanna Corp.*, 380 F.2d 262, 269-70 (7th Cir.) (concurring opinion of two of three judges; corporate acquisition of own stock for excessive price), *cert. denied*, 389 U.S. 977 (1967). Although the district court in *Dasho* found no misrepresentation or concealment (267 F. Supp. 508, 512 (N.D. Ill. 1966)), the concurring court of appeals judges found fraud in the defendants' failure "to disclose [their] adverse personal interest." 380 F.2d at 266. One of the most important considerations underlying the court's holding was the inadequacy of the consideration paid for the stock. Read from this perspective, *Dasho* is broader than *Swanson*. However, when *Dasho* was appealed to the Seventh Circuit a second time, the court of appeals analyzed the case in terms of deception. See *Dasho v. Susquehanna Corp.*, 461 F.2d 11, 25-26 (7th Cir.), *cert. denied*, 408 U.S. 925 (1972). *Condon v. Richardson*, 411 F.2d 489, 492 (7th Cir. 1969), can be viewed as either a "new fraud" case or as a deception case in which one director was selling securities to the issuer. Significantly, the court stated that 10b-5 violations may arise even though the hoard is fully informed. *Id.*

In view of these cases and *Schoenbaum*, *Ross v. Longchamps, Inc.*, 336 F. Supp. 434, 439 (E.D. Mo. 1971), involving the dismissal of a case based on a transaction between a parent and a 53%-owned subsidiary on the ground of no deception, was decided incorrectly.

<sup>196</sup> Each of the cases cited in notes 193-95 *supra* involved a benefit, although not necessarily a monetary one, to the defendants. Judge Smith's dissenting opinion in *Drachman v. Harvey*, 453 F.2d 722, 735 (2d Cir. 1971), *rev'd on rehearing en banc*, 453 F.2d 736 (2d Cir. 1972), appears to expand the Second Circuit's "new fraud" concept to include any purchases that benefit the controlling stockholder.

<sup>197</sup> The Third Circuit case involved a sale for inadequate consideration to directors and other purchasers. The directors were held responsible for damages with respect to all shares. *Pappas v. Moss*, 393 F.2d 865, 869 (3d Cir. 1968), *on remand*, 303 F. Supp. 1257, 1279, 1281 (D.N.J. 1969). *Dasho v. Susquehanna Corp.*, 380 F.2d 262, 269-70 (7th Cir.), *cert. denied*, 389 U.S. 977 (1967), involved a sale by the corporation to a dissident stockholder group. The sale, made for inadequate consideration in order to silence the dissenting group's objections, was held to be a Rule 10b-5 violation.

One early district court decision in the Second Circuit seems to have gone this far as well. See *New Park Mining Co. v. Cranmer*, 225 F. Supp. 261, 264-65, 267 (S.D.N.Y. 1963).

<sup>198</sup> *Rekant v. Desser*, 425 F.2d 872, 882 (5th Cir. 1970), *quoted in* *Wolf v. Frank*, 477 F.2d 467, 477 (5th Cir. 1973); *cf.* *Shell v. Hensley*, 430 F.2d 819, 827 (5th Cir. 1970) (purchase of assets for excessive consideration; no deceit necessary if other party to transaction controls board or conspires with board).

Eighth Circuit also has adopted a far-reaching rule which condemns any securities transaction in which self-dealing violative of fiduciary obligations can be found, even if the insiders' benefits arise indirectly out of a trade between the issuer and outsiders.<sup>199</sup>

"New fraud" principles should, of course, apply to an alleged violation emanating from actions of officers or a committee of the board.

### 3. Negligence

Negligence is a possible alternative to deception and "new fraud." There is some authority for the proposition that negligent mismanagement is actionable under the Rule.<sup>200</sup> But this reasoning is somewhat inconsistent with cases holding that Rule 10b-5 does not reach all breaches of fiduciary obligation.<sup>201</sup>

### C. The Causation and Reliance Elements

Analyses of causation and reliance are often intermingled in mismanagement decisions.<sup>202</sup> Even when discussed separately, their individual roles are unclear. Although causation is a necessary element in all 10b-5 suits,<sup>203</sup> a less stringent standard suffices for injunc-

<sup>199</sup> *Travis v. Anthes Imperial Ltd.*, 473 F.2d 515, 519, 527-28 (8th Cir. 1973) (tender offer followed by merger claimed to result in increased voting control, improved dividends, and higher salaries and benefits for defendants).

<sup>200</sup> *Nanfito v. Tekseed Hybrid Co.*, 341 F. Supp. 240, 243 n.2 (D. Neb. 1972) (negligence enough); *Nanfito v. Tekseed Hybrid Co.*, 341 F. Supp. 234, 239 (D. Neb. 1972); see *Dasho v. Susquehanna Corp.*, 461 F.2d 11, 25 (7th Cir.), cert. denied, 408 U.S. 925 (1972) (nondisclosure to corporation not actionable if majority of directors fully-informed, disinterested, and "if in the good faith exercise of their business judgment" they acted in best interests of company); *Knauff v. Utah Constr. & Mining Co.*, 408 F.2d 958, 965 (10th Cir.), cert. denied, 396 U.S. 831 (1969) (test whether reasonably prudent judgment exercised). *Contra*, *Kaplan v. Newman*, [1970-1971 Transfer Binder] CCH FED. SEC. L. REP. ¶ 93,134, at 91,111 (E.D.N.Y. 1971) (conscious wrongdoing ordinarily required); *Mader v. Armel*, [1970-1971 Transfer Binder] CCH FED. SEC. L. REP. ¶ 93,027, at 90,798 (S.D. Ohio 1971) (negligence possible basis for injunction, but not for damages under 10b-5); *Carliner v. Fair Lanes, Inc.*, 244 F. Supp. 25, 29 (D. Md. 1965) (director's action beyond business judgment, but no 10b-5 cause of action because no deception); see *Alameda Oil Co. v. Ideal Basic Indus., Inc.*, 337 F. Supp. 194, 195-96 (D. Colo. 1972) (no evidence "directors acted in bad faith or with willful and intentional disregard of the rights and interests of the stockholders"; 10b-5 complaint dismissed). See also *Berman v. Thomson*, 312 F. Supp. 1031, 1035 (N.D. Ill. 1970) (no defense to claim of misrepresentation in merger proxy statement that directors "exercised good faith and honest business judgment"); *Entel v. Allen*, 270 F. Supp. 60, 70 (S.D.N.Y. 1967) (10b-5 includes undisclosed breach of state corporate fiduciary law).

<sup>201</sup> See note 28 and accompanying text *supra*.

<sup>202</sup> *Gould v. American Hawaiian S.S. Co.*, 319 F. Supp. 795, 802 n.12 (D. Del. 1970); *Adair v. Schneider*, 293 F. Supp. 393, 396 (S.D.N.Y. 1968); Note, *Causation and Liability in Private Actions for Proxy Violations*, 80 YALE L.J. 107, 137 (1970).

<sup>203</sup> See, e.g., *Review 71 v. Alloys Unlimited, Inc.*, 450 F.2d 482, 485-86 (10th Cir. 1971);

the speculative abuse of confidential information by corporate insiders. Rule 10b-5 has none of the inherent limitations that circumscribe the application of section 16(b). There is neither a six-month trading requirement nor a short statute of limitations. Rule 10b-5 applies to any person, insider or outsider, as well as to any security, equity, or debt, whether or not traded on a national securities exchange, in the over-the-counter markets, or privately held.<sup>64</sup> Moreover, a private action initiated under rule 10b-5 may be direct, derivative, or a combination of both. Literally thousands of cases, many dealing with speculative abuses of confidential information by corporate insiders, have been initiated under the rule within the last twenty years.<sup>65</sup> And since the Securities and Exchange Commission's recent successful suit against certain officers and directors of the Texas Gulf Sulphur Company, section 10(b) and rule 10b-5 may well become the principal bases for all actions grounded upon a theory of insider abuse of confidential corporate information.<sup>66</sup>

The vast body of federal corporate common law, based upon section 10(b) and rule 10b-5, has enabled the federal courts to protect the investing public against insider abuses with flexibility and imagination.<sup>67</sup>

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<sup>64</sup> Rule 10b-5 provides:

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails, or of any facility of any national securities exchange,

- (1) to employ any device, scheme, or artifice to defraud,
- (2) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
- (3) to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any persons, in connection with the purchase or sale of any security.

17 C.F.R. § 240.10b-5 (1968). See also PRACTICING LAW INSTITUTE, S.E.C. PROBLEMS OF CONTROLLING STOCKHOLDERS AND IN UNDERWRITINGS 140 (C. Israel ed. 1962).

<sup>65</sup> Today, it is settled in virtually every circuit that an implied private remedy may be granted for damages resulting from the violation of § 10(b) and rule 10b-5. *Boone v. Baugh*, 308 F.2d 711 (8th Cir. 1962); *Estate Counseling Serv., Inc. v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 303 F.2d 527 (10th Cir. 1962); *Texas Continental Life Ins. Co. v. Dunne*, 307 F.2d 242 (6th Cir. 1962); *Hooper v. Mountain States Sec. Corp.*, 282 F.2d 195 (5th Cir. 1960), cert. denied, 365 U.S. 814 (1961); *Errion v. Connell*, 236 F.2d 447 (9th Cir. 1956); *Speed v. Transamerica Corp.*, 235 F.2d 369 (3d Cir. 1956); *Fischman v. Raytheon Mfg. Co.*, 188 F.2d 783 (2d Cir. 1951).

In addition, dicta in other circuits and acceptance of this theory by federal district courts indicates approval of the doctrine of implied civil liability pursuant to rule 10b-5. See, e.g., *Kohler v. Kohler Co.*, 208 F. Supp. 808 (E.D. Wis. 1962), aff'd, 319 F.2d 634 (7th Cir. 1963); *Nash v. J. Arthur Warner & Co.*, 137 F. Supp. 615 (D. Mass. 1955).

<sup>66</sup> *SEC v. Texas Gulf Sulphur Co.*, 1968 CCH FED. SEC. L. REP. ¶ 92,251 (2d Cir. Aug. 13, 1968).

<sup>67</sup> See Fleischer, "Federal Corporation Law": An Assessment, 78 HARV. L. REV. 1146 (1965); Lowenfels, *Rule 10b-5 and the Stockholder's Derivative Action*, 18 VAND.

The very policies that were emphasized in the 1934 congressional committee discussions and reports in connection with the enactment of section 16(b) are now being implemented under section 10(b) and rule 10b-5.<sup>68</sup> There is no longer any reason for the federal courts to be harsh and objective in interpreting and applying section 16(b). Everything that this section was designed to accomplish, and much more, is presently being accomplished under section 10(b) and rule 10b-5. Indeed, in recent years section 16(b) has become a trap and a snare for the unsophisticated or the poorly counseled, especially in connection with corporate mergers, reclassifications, conversions of securities and the like.<sup>69</sup> The recent subjective trend is a manifestation of dissatisfaction with this traditional, objective interpretation of section 16(b) and a warning by the federal appellate courts that this section will no longer be applied blindly to situations which cannot possibly lend themselves to the kind of speculation that the statute was designed to prevent.

Concomitant with these developments under federal law has been a limited, parallel development under state law. In the recent New York case of *Diamond v. Oreamuno*,<sup>70</sup> the appellate division held that officers and directors utilizing inside information to reap profits by trading in the securities of their corporation may be liable under state law to their corporation for any profits realized. The court reasoned that these officers and directors were converting a corporate asset, specifically inside information, to their own personal use and profit, and as agents and fiduciaries they were bound to hold any profits realized from such activities in constructive trust for their principal, the corporation. The *Diamond* case is particularly significant because it illustrates another set of rights, based upon state law, which may be utilized to remedy an abuse of confidential corporate information by insiders. And, with the recent growth and development of the doctrine of pendent jurisdiction, these rights may often be asserted in the federal courts as part of a federal claim, as well as in the state courts as a purely state claim.<sup>71</sup>

With all the rights and remedies available to curb the unfair use of confidential corporate information by insiders, there is no longer any

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L. REV. 893 (1965); Lowenfels, *The Demise of the Birnbaum Doctrine: A New Era for Rule 10b-5*, 54 VA. L. REV. 268 (1968).

<sup>68</sup> See pp. 59-61 *supra*.

<sup>69</sup> See *Heli-Coil Corp. v. Webster*, 352 F.2d 156 (3d Cir. 1965); *Western Auto Supply Co. v. Gamble-Skogmo Inc.*, 348 F.2d 736 (8th Cir. 1965), *cert. denied*, 382 U.S. 987 (1966); *Marquette Cement Mfg. Co. v. Andreas*, 239 F. Supp. 962 (S.D.N.Y. 1965).

<sup>70</sup> 29 App. Div. 2d 285, 287 N.Y.S.2d 300 (1st Dep't 1968).

<sup>71</sup> See Lowenfels, *Pendent Jurisdiction and the Federal Securities Acts*, 67 COLUM. L. REV. 474 (1967).

reason for the federal courts to follow the harsh principles of *Smolowe* and *Park & Tilford*.<sup>72</sup> The Draconian impact of these early decisions belongs to another era. Today the courts can be particularly cognizant of the policies and purposes underlying section 16(b), and, with the perspective of recent developments under federal and state law, and can deal with each individual fact situation on its own particular merits.

#### CONCLUSION

The logical extension of a number of the arguments set out in the preceding section would be the advocacy of the repeal of section 16(b). Thirty years of experience with the federal securities laws has demonstrated the validity of the proposition that no rigid doctrine, no hard and fast rule, will successfully prevent fraud. If such black letter rubric is enacted, then clever men will always find ways to evade, to circumvent, to perpetrate their wrongdoings without incurring liability.<sup>73</sup> The clear lines of liability drawn by section 16(b), particularly the six month trading requirement, have prompted the federal courts to look elsewhere for statutory support in attempting to curb securities fraud. Moreover, in many ways section 16(b) has become the very antithesis of what the legislature intended. Instead of a bar to the realization of profits by corporate insiders from speculative abuses of inside information, it has become a trap for unsophisticated and poorly counseled businessmen innocently engaged in mergers, reclassifications or conversions of securities. To advocate the outright repeal of section 16(b), however, is not a very pragmatic approach. Congress has many more pressing and important problems than the fate of one comparatively obscure provision of the federal securities laws. Rather, the solution would seem to lie with the federal courts. The development and extension of the subjective interpretation of section 16(b), the refusal to apply this "crude rule-of-thumb" to situations which could not possibly lend themselves to the types of abuses that the statute was designed to prevent—herein lies the most practical solution to what has in reality become a statutory anachronism.

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<sup>72</sup> See pp. 46-50 *supra*.

<sup>73</sup> As was stated in *State v. Whiteaker*:

We do not deem it advisable to lay down any hard and fast rule . . . . Were we to do so, a certain class of gentlemen of the "J. Rufus Wallingford" type—"they toil not neither do they spin"—would lie awake nights endeavoring to conceive some devious and shadowy way of evading the law. It is more advisable to deal with each case as it arises.

118 Ore. 656, 661, 247 P. 1077, 1079 (1926).