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Convertible Securities and Section 16(b): The persistent Problems of Purchase, Sale, and Debts Previously Contracted

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COMMENTS

Convertible Securities and Section 16(b): The Persistent Problems of Purchase, Sale, and Debts Previously Contracted

In 1934, Congress enacted section 16(b) of the Securities Exchange Act[1] in an effort to counteract the evils flowing from speculation in corporate securities by certain persons having information regarding the corporation's affairs or occupying positions of trust which permit manipulation of corporate policies.[2] In general, section 16(b) permits the issuer, or one or more stockholders acting in its behalf, to recover any "short-swing" profit realized from purchases and sales (or sales and purchases) of the issuer's equity securities within a six-month period by directors,[3] officers,[4] or beneficial owners of more than ten per cent of any class of equity securities.[5] Once these statutory conditions are satisfied, it is irrelevant that the insider did not actually make use of privileged information[6] or, indeed, that he sold his stock for the corporation's benefit and at its request.[7]

The incidence of section 16(b), however, is also highly restricted, and it does not strip the corporate insider of all of his natural advantages. For instance, recovery is limited to transactions completed within a six-month span. Thus, an insider utilizing privileged information may with impunity dispose of his securities one day after

1. 48 Stat. 896 (1934), 15 U.S.C. § 78p(b) (1964).

2. The abuses which § 16(b) was designed to prevent were disclosed by an extensive investigation into stock exchange practices conducted by the Senate Committee on Banking and Currency. See *Hearings on S. Res. 84 and S. Res. 56 & 97 Before the Senate Committee on Banking and Currency*, 73d Cong., 1st & 2d Sess. pt. 15 (1934). For a thorough discussion of the practices leading up to the enactment of § 16(b), see Cook & Feldman, *Insider Trading Under the Securities Exchange Act* (pt. 1), 66 HARV. L. REV. 385 (1953); Rubin & Feldman, *Statutory Inhibitions Upon Unfair Use of Corporate Information by Insiders*, 95 U. PA. L. REV. 468 (1947); Yourd, *Trading in Securities by Directors, Officers and Stockholders: Section 16 of the Securities Exchange Act*, 38 MICH. L. REV. 133 (1939).

3. "The term 'director' means any director of a corporation or any person performing similar functions with respect to any organization, whether incorporated or unincorporated." 48 Stat. 883 (1934), 15 U.S.C. § 78c(a)(7) (1964).

4. "The term 'officer' means a president, vice-president, treasurer, secretary, comptroller, and any other person who performs for an issuer, whether incorporated or unincorporated, functions corresponding to those performed by the foregoing officers." SEC Reg. X-3B-2, 17 C.F.R. § 240.3b-2 (1964). Although the definition seems to be explicit, there is substantial disagreement among the authorities. See 2 LOSS, SECURITIES REGULATION 1081-94 (2d ed. 1961).

5. See generally 2 Loss, *op. cit. supra* note 4, at 1100-08.

6. See Smolowe v. Delendo Corp., 136 F.2d 231, 235-36 (2d Cir.), *cert. denied*, 320 U.S. 751 (1943); text accompanying notes 84 and 85 *infra*.

7. See Heli-Coil Corp. v. Webster, 352 F.2d 156 (3d Cir. 1965); Magida v. Continental Can Co., 231 F.2d 843 (2d Cir.), *cert. denied*, 351 U.S. 972 (1956).

the expiration of the statutory period.[8] Furthermore, there is no attempt to cover situations where the insider "advises" his friends[9] or exchanges tips with insiders in other companies,[10] and the statute does not actually prohibit the use of inside information in short-swing transactions; it simply takes the profit out of such activity.[11] Finally, the act contains an express exception which provides that an insider is not liable for profits from short-swing transactions in securities if the securities were "acquired in good faith in connection with a debt previously contracted."[12] In general, however, the courts have construed section 16(b) very liberally, permitting recovery on the basis of somewhat nebulous, and even inconsistent, theories.[13] The result has been that whenever an insider purchases and sells the same or closely related equity securities within a six-month period, liability for realized profits is almost automatic.[14]

The principal difficulty in applying section 16(b) is that of determining what Congress intended by the use of the terms "purchase" and "sale." The statutory definitions are extremely sketchy, providing only that the term "purchase" includes "any contract to buy,

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8. B. T. Babbitt, Inc. v. Lachner, 332 F.2d 255, 258 (2d Cir. 1964).

9. Earlier drafts of the insider-trading provision had much broader coverage than the language which now appears in § 16(b). Section 15(b) of both S. 2693 and H.R. 7852, 73d Cong., 2d Sess. (1934), provided: "It shall be unlawful for any director, officer, or [beneficial owner of five per cent of any class of stock] . . . (3) To disclose, directly or indirectly, any confidential information regarding or affecting any such registered security. . . . Any profit made by any person, to whom such unlawful disclosure shall have been made, in respect of any transaction . . . within a period not exceeding 6 months after such disclosure shall inure to and be recoverable by the issuer unless such person shall have had no reasonable ground to believe that the disclosure was confidential. . . ." This sweeping forfeiture provision was apparently omitted from the final act because of anticipated problems of administration. See Rattner v. Lehman, 193 F.2d 564, 566 (2d Cir. 1952); Smolowe v. Delendo Corp., 136 F.2d 231, 236 (2d Cir.), *cert. denied*, 320 U.S. 751 (1943).

10. *Cf.* Blau v. Lehman, 368 U.S. 403, 414-23 (1962) (dissenting opinion). See Cole, *Insiders' Liabilities Under the Securities Exchange Act of 1934*, 12 SW. L.J. 147, 150 n.22 (1958); Comment, 50 CALIF. L. REV. 500 (1962); Note, 14 STAN. L. REV. 192, 199 (1961).

11. Denial of profit to insiders is imposed as an administrative sanction and not upon any theory that such profits belong to the corporation by reason of a property right. See Brudney, *Insider Securities Dealings During Corporate Crises*, 61 MICH. L. REV. 1, 7 (1962). Moreover, § 16(b) is considered to be prophylactic rather than penal. See Booth v. Varian Associates, 334 F.2d 1, 3 (1st Cir. 1964), *cert. denied*, 379 U.S. 961 (1965); Adler v. Klawans, 267 F.2d 840, 844 (2d Cir. 1959). *But see* Painter, *The Evolving Role of Section 16(b)*, 62 MICH. L. REV. 649, 650 (1964), where the author points out that since recoveries are maximized wherever possible, the statute has acquired quasi-penal overtones.

12. 48 Stat. 896 (1934), 15 U.S.C. § 78p(b) (1964).

13. See Booth v. Varian Associates, 334 F.2d 1, 4 (1st Cir. 1964), *cert. denied*, 379 U.S. 961 (1965); Halleran & Calderwood, *Effect of Federal Regulation on Distribution of and Trading in Securities*, 28 GEO. WASH. L. REV. 86, 114 (1959); Painter, *supra* note 11, at 650.

14. See Smolowe v. Delendo Corp., 136 F.2d 231 (2d Cir.), *cert. denied*, 320 U.S. 751 (1943); 2 Loss, *op. cit. supra* note 4, at 1043; Comment, 59 YALE L.J. 510, 513 (1950); Note, 107 U. PA. L. REV. 719, 721 (1959).

purchase, or otherwise acquire"[15] and that the term "sale" includes "any contract to sell or otherwise dispose of" a security.[16] Since many types of transactions are neither clearly within nor clearly without the contemplation of this vague statutory language, section 16(b) is regarded as one of the most ambiguous provisions of all the New Deal securities legislation.[17]

There has been considerable litigation concerning the proper construction of these terms in various types of specialized securities transactions. The principal areas of confusion have developed in connection with receipt and exercise of warrants to purchase stock,[18] exercise of stock options granted in consideration of an insider's services,[19] exchange of stock pursuant to a corporate reorganization or simplification,[20] and, most significantly, conversion of preferred stock or debentures into the issuer's common stock.[21] Due primarily to the large number of recent cases involving convertible securities, the following effort to delineate the scope of section 16(b) will be undertaken in the context of conversion transactions. However, all of the foregoing transactions are closely related, and thus it would appear that the general principles underlying the broad concepts of "purchase" and "sale" should apply uniformly in all of these situations.[22]

15. 48 Stat. 882 (1934), 15 U.S.C. § 78c(a)(13) (1964).

16. 48 Stat. 882 (1934), 15 U.S.C. § 78c(a)(14) (1964).

17. See Halleran & Calderwood, *supra* note 13, at 114.

18. See Shaw v. Dreyfuss, 172 F.2d 140 (2d Cir.), *cert. denied*, 337 U.S. 907 (1949); Truncale v. Blumberg, 88 F. Supp. 677 (S.D.N.Y.), *aff'd per curiam sub nom.* Truncale v. Scully, 182 F.2d 1021 (2d Cir. 1950); Truncale v. Blumberg, 80 F. Supp. 387 (S.D.N.Y. 1948).

19. See Kornfeld v. Eaton, 327 F.2d 263 (2d Cir. 1964); Greene v. Dietz, 247 F.2d 689 (2d Cir. 1957); Blau v. Ogsbury, 210 F.2d 426 (2d Cir. 1954); Walet v. Jefferson Lake Sulphur Co., 202 F.2d 433 (5th Cir.), *cert. denied*, 346 U.S. 820 (1953); Perlman v. Timberlake, 172 F. Supp. 246 (S.D.N.Y. 1959); Steinberg v. Sharpe, 95 F. Supp. 32 (S.D.N.Y. 1950), *aff'd per curiam*, 190 F.2d 82 (2d Cir. 1951). See generally Halleran, *The Impact of Section 16(b) of the Securities Exchange Act of 1934 on Restricted Stock Options*, 15 BUS. LAW. 158 (1959).

20. See Booth v. Varian Associates, 334 F.2d 1 (1st Cir. 1964), *cert. denied*, 379 U.S. 961 (1965); Roberts v. Eaton, 212 F.2d 82 (2d Cir.), *cert. denied*, 348 U.S. 827 (1954); Blau v. Mission Corp., 212 F.2d 77 (2d Cir.), *cert. denied*, 347 U.S. 1016 (1954); Blau v. Hodgkinson, 100 F. Supp. 361 (S.D.N.Y. 1951).

21. See Heli-Coil Corp. v. Webster, 352 F.2d 156 (3d Cir. 1965); B. T. Babbitt, Inc. v. Lachner, 332 F.2d 255 (2d Cir. 1964); Ferraiolo v. Newman, 259 F.2d 342 (6th Cir. 1958), *cert. denied*, 359 U.S. 927 (1959); Park & Tilford, Inc. v. Schulte, 160 F.2d 984 (2d Cir.), *cert. denied*, 332 U.S. 761 (1947); Blau v. Lamb, 242 F. Supp. 151 (S.D.N.Y. 1965); Blau v. Lamb, 163 F. Supp. 528 (S.D.N.Y. 1958). *Cf.* Blau v. Max Factor & Co., 342 F.2d 304 (9th Cir.), *cert. denied*, 86 Sup. Ct. 180 (1965).

22. *Cf.* Roberts v. Eaton, 212 F.2d 82 (2d Cir.), *cert. denied*, 348 U.S. 827 (1954); Blau v. Ogsbury, 210 F.2d 426, 427 (2d Cir. 1954). As originally enacted, § 16(b) applied only to securities which were registered on a national securities exchange. However, the scope of the statute has been enlarged recently by the Securities Acts Amendments of 1964 to encompass a large number of issuers whose securities are traded over the counter. 78 Stat. 565, 15 U.S.C. § 78*l* (1964). See Little, *Practical Implications of the Recent Federal Securities Legislation for the Over-the-Counter Company*, 10 PRAC. LAW. No. 7, at 43 (1964).

I. The Elusive Meaning of "Purchase" and "Sale"

Corporate securities which may be exchanged, at the owner's option, for a different class of securities of the same or an affiliated corporation are considered to be convertible.[23] Generally, convertible issues are reasonably secure investments, such as bonds or preferred stock, which provide a fixed return on capital.[24] In contrast, the underlying or "conversion" security is frequently common stock, which is more speculative but offers a possibility for greater future income and market appreciation. It is evident that, from the standpoint of the investor, the attraction of a convertible issue is based upon its combination of these two distinct factors—current income and potential growth in value. The income feature, which inheres in a convertible security by reason of its being a direct obligation of the issuer,[25] is independent of the conversion privilege. On the other hand, the opportunity for capital appreciation is a concomitant of the right to convert to the underlying common stock. With respect to the issuer, the presence in a convertible security of the two elements of income and capital appreciation enables it to obtain a greater market price for an issue than otherwise would be possible without the conversion feature.[26] Thus, convertible securities are in effect a device which permits the issuer to acquire present capital in return for the purchaser's right to participate in future profits.

A. *Early Developments and Overly Broad Statements of the Law*

The application of section 16(b) to cases involving convertible securities is made difficult by the fact that an insider who acquires such a holding also has a real interest in the underlying stock.[27] If, for example, the market price of the underlying stock rises above the conversion price, the value of the convertible security increases proportionately. Conversely, if the market price of the underlying stock declines, the price of the convertible security is correspondingly reduced until it reaches a level where it is supported by its inherent qualities as a bond or preferred stock.[28] Indeed, as long

23. See generally 1 Dewing, Financial Policy of Corporations 256 (5th ed. 1953); Hills, *Convertible Securities—Legal Aspects and Draftsmanship*, 19 Calif. L. Rev. 1 (1930).

24. 1 Dewing, *op. cit. supra* note 23, at 256-58.

25. *Id.* at 269.

26. *Id.* at 268.

27. See Falco v. Donner Foundation, Inc., 208 F.2d 600, 603 (2d Cir. 1953), where the court stated in dictum: "for all practical purposes a convertible bond is equivalent to the number of shares of stock into which it is convertible." See generally Cook & Feldman, *supra* note 2, at 624; Note, 72 Harv. L. Rev. 1392, 1394 (1959); Note, 59 Harv. L. Rev. 998, 999 (1946).

28. See generally 1 Dewing, *op. cit. supra* note 23. *Cf.* Ferraiolo v. Newman, 259 F.2d 342 (6th Cir. 1958), *cert. denied*, 359 U.S. 927 (1959).

as the conversion privilege remains viable and the price of the underlying stock exceeds the conversion price, the value of the convertible security is determined by the market valuation placed upon the conversion security.[29] Thus, in the absence of market manipulation or similar unconscionable activity, it would appear that an insider can achieve no greater speculative advantage by converting his debentures or preferred stock and selling the underlying common stock than by pursuing the direct course of disposing of the convertible security itself. Nevertheless, the courts have expressed widely divergent, and somewhat irreconcilable, views on the subject of short-swing conversions and sales by insiders.

The first major court of appeals decision to consider the implications of the foregoing interrelationship between convertible and conversion securities in the context of section 16(b) was *Park & Tilford v. Schulte.*[30] The defendants owned both a majority of the outstanding common stock and 6,604 shares of convertible preferred, which, unlike the common, was not listed on a securities exchange. The preferred was redeemable on ninety days' notice at a price of fifty-five dollars per share, with the holder having a right to exercise his conversion privilege any time before the final redemption date. In December 1943 the corporation gave notice that the preferred was to be redeemed. However, from the latter part of 1943 until May 1944 the market price of the common underwent a spectacular rise because of a rumor that the issuer was about to declare a dividend in kind (liquor) on its common stock. During January 1944 the defendants exercised their conversion right, and within six months they sold the common stock thus acquired for prices as high as ninety-eight dollars per share.

The issuing corporation instituted an action to recover the short-swing profits. The district court allowed recovery, and its decision was affirmed by the Court of Appeals for the Second Circuit. Without even discussing the possibilities for abuse of confidential information in the context of this particular transaction, the court stated:

> We think a conversion of preferred into common stock followed by a sale within six months is a "purchase and sale" within the statutory language of § 16(b). Whatever doubt might otherwise exist as to whether a conversion is a "purchase" is dispelled by definition of "purchase" to include "any contract to buy, purchase, or otherwise acquire." . . . 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.[31]

29. Ferraiolo v. Newman, *supra* note 28, at 345.

30. 160 F.2d 984 (2d Cir.), *cert. denied*, 332 U.S. 761 (1947).

31. *Id.* at 987. Although the decision is generally regarded as correct in relation to the particular facts before the court, the opinion has received frequent criticism

This approach to the definitional problem, termed the strict or all-inclusive view,[32] clearly indicates an intent to give the broadest possible construction to the terms "purchase" and "sale," and eliminates any possibility of discretionary administration of a statute which is designed to obviate all incentive to abuse inside information.[33]

Other courts, however, confronted with different fact situations, soon found that the sweeping language of the opinion required modification.[34] The inroads upon the broad generalizations found throughout the *Park & Tilford* opinion eventually culminated in the Sixth Circuit decision of *Ferraiolo v. Newman*.[35] In that case, the court held that the receipt of common stock of the Ashland Oil and Refining Company in exchange for its convertible preferred was not a "purchase." *Park & Tilford* was distinguished on several grounds. First, Judge Potter Stewart pointed out that whereas the defendants in *Park & Tilford* were in actual control of the corporation, the defendant director in *Ferraiolo* assumed only a passive role in corporate affairs. Judge Stewart concluded from this that the conversion of the Ashland preferred had been genuinely forced by the board of directors, by means of a call for redemption made at a time when the price of the common (and consequently the preferred as well) substantially exceeded the call price. Second, the court emphasized the fact that the Ashland convertible preferred, as well as the common, was listed and actively traded. Third, unlike the situation in *Park & Tilford*, the conversion privilege attached to the Ashland preferred could not be diluted[36] by a stock split or stock dividend which would increase the number of common shares. On the basis of these factors, the court concluded that the effect of Ashland's call of the preferred was simply to force the surrender of the preference feature and that in reality the preferred and common stocks of Ashland were "economic equivalents." In explaining its decision, the court stated: "Newman's conversion of Ashland preferred to Ashland common had none of the economic indicia of a

for propounding an indefensibly broad rule. Most commentators feel that the decision could have rested on the fact that the convertible preferred was closely held and essentially nonmarketable, so that the conversion to common, which was readily marketable, gave the defendants a real change in speculative opportunity. See 2 Loss, *op. cit. supra* note 4, at 1067; Note, 36 U. DET. L.J. 343, 346 (1959). *But see* Note, 59 HARV. L. REV. 998 (1946).

32. See Note, 49 IOWA L. REV. 1346, 1350 (1964); Comment, 11 STAN. L. REV. 358, 359 (1959).

33. See Meeker & Cooney, *The Problem of Definition in Determining Insider Liabilities Under Section 16(b)*, 45 VA. L. REV. 949 (1959); Comment, 11 STAN. L. REV. 358 (1959).

34. For a detailed account of subsequent developments, see Cole, *supra* note 10, at 161.

35. 259 F.2d 342 (6th Cir. 1958), *cert. denied*, 359 U.S. 927 (1959).

36. For an explanation of the term "dilution" in the context of securities transactions, see note 46 *infra* and accompanying text.

purchase; it created no opportunity for profit which had not existed since 1948. The transaction was not one that could have lent itself to the practices which Section 16(b) was enacted to prevent."[37]

B. *Recent Developments*

Despite the numerous distinctions between the Ashland and Park & Tilford preferred stock and the dissimilar circumstances of the exchange of those securities for the underlying common stock, the *Ferraiolo* decision was widely acclaimed as having rejected any application of the *Park & Tilford* doctrine beyond the specific facts of that case.[38] While the Second Circuit has not had any opportunity to re-examine its prior reasoning, at least two of that court's recent opinions indicate that it still regards the sweeping rule in *Park & Tilford* as an accurate statement of the law in cases involving convertible securities.[39] In contrast, however, the Court of Appeals for the Ninth Circuit recently cited *Ferraiolo* with approval and held that where an issuer's common and convertible class A stocks were equally marketable and both securities were traded at precisely the same price, a conversion would not be a "purchase" of the common within the meaning of section 16(b).[40]

In the most recent case involving this interpretative controversy, *Heli-Coil Corp. v. Webster*,[41] the Court of Appeals for the Third Circuit was presented with factors similar to those relied upon by the defendants in both *Park & Tilford* and *Ferraiolo*. On November 20, 1958, defendant Webster, a director of Heli-Coil, acquired debenture bonds which were convertible into the common stock of the plaintiff corporation at the option of the bondholder. About three months later, the investment banking firm that advised the issuer on financial matters suggested to the defendant that he convert

37. 259 F.2d 342, 346 (6th Cir. 1958), *cert. denied*, 359 U.S. 927 (1959). As in the case of the language in *Park & Tilford*, this statement has also been criticized for being overly broad. See, *e.g.*, Meeker & Cooney, *supra* note 33; Comment, 11 STAN. L. REV. 358 (1959); Note, 107 U. PA. L. REV. 719 (1959).

38. See, *e.g.*, Note, 72 HARV. L. REV. 1392, 1394 (1959); Note, 36 U. DET. L.J. 343, 347 (1959).

39. In the first of these two cases, Blau v. Lehman, 286 F.2d 786 (2d Cir. 1960), *aff'd*, 368 U.S. 403 (1962), the defendant's partnership had acquired common stock, exchanged it for a new preferred issue pursuant to a voluntary recapitalization plan, and then sold the preferred—all within six months. In order to compute the amount of profit realized by the defendant partner, it was necessary to determine the purchase date. After citing *Park & Tilford*, Judge Medina held that the "purchase" occurred on the date of conversion. *Id.* at 792. In the second case, Judge Kaufman stated that "it is clear that a conversion of preferred into common is a purchase within the meaning of § 16(b)," but no liability resulted, because of failure to show any realization of profit. B. T. Babbitt, Inc. v. Lachner, 332 F.2d 255, 258 (2d Cir. 1964).

40. Blau v. Max Factor & Co., 342 F.2d 304 (9th Cir.), *cert. denied*, 86 Sup. Ct. 180 (1965).

41. 352 F.2d 156 (3d Cir. 1965). The district court decision is discussed in Note, 49 IOWA L. REV. 1346 (1964).

his debentures, since the elimination of this indebtedness would "make a better statement." For this reason, and because he needed cash for personal expenses, on March 18, 1959, defendant voluntarily exercised his privilege to convert. Subsequently, within six months of the conversion date, but more than six months after acquiring the bonds, he sold common stock at a profit. During the entire eight-month period in question, the market price of Heli-Coil common was constantly rising, a trend which continued throughout 1959. Although the court conceded that the common stock was the economic equivalent of the debentures and that it was difficult to perceive how Webster could have obtained an economic advantage from the conversion,[42] it concluded that conversions should be controlled by a strict "rule of thumb." It therefore held the exchange to be a "sale"[43] of the debentures and a "purchase" of the stock.

C. *Fine Lines of Distinction*

The failure of the courts to articulate the basic rationale underlying their decisions in the conversion cases has left this area of the law in a state of confusion. This outward appearance is made more disturbing because of the fact that, after the *Park & Tilford* decision, there has been general agreement on the test of liability, as stated in *Ferraiolo*: "Every transaction which can reasonably be defined as a purchase will be so defined, if the transaction is of a kind which can possibly lend itself to the speculation encompassed by section 16(b)."[44] Thus, although the statute explicitly proscribes any inquiry as to whether an insider is acting upon confidential information, it is equally clear that the foregoing test of liability requires an investigation into the facts of a questioned transaction to see whether confidential information *could* be utilized to the detriment of outside shareholders. In this respect, it appears that the *Heli-Coil* opinion has departed from the precedent established by earlier decisions under section 16(b) and has also disregarded the realities of that particular case, since there was no showing of circumstances which would have made it possible for the defendant to exploit his position as an insider. In contrast, all of the earlier opinions dealing with short-swing conversion transactions have devoted considerable attention to the effect of one or more of the following factors:

42. *Id.* at 164-65.

43. *Heli-Coil* was the first decision to hold that a conversion was a "sale" as well as a "purchase." Subsequently this view was adopted in Blau v. Lamb, 242 F. Supp. 151 (S.D.N.Y. 1965).

44. 259 F.2d at 345. *Accord*, Blau v. Max Factor & Co., 342 F.2d 304, 307 (9th Cir.), *cert. denied*, 86 Sup. Ct. 180 (1965); Blau v. Lehman, 286 F.2d 786, 792 (2d Cir. 1960), *aff'd*, 368 U.S. 403 (1962); Blau v. Lamb, 242 F. Supp. 151, 157 (S.D.N.Y. 1965); Heli-Coil Corp. v. Webster, 222 F. Supp. 831, 835 (D.N.J. 1963), *aff'd*, 352 F.2d 156 (3d Cir. 1965).

whether the convertible issue is subject to dilution by an increase in the number of underlying common shares, whether the convertible and conversion securities are equally marketable, and whether the conversion was "forced" by a corporate redemption of the convertible issue. None of these three factors is conclusive with respect to the question of liability, but all should nevertheless be examined to determine whether there is any way an insider could have misused privileged information.

1. *Dilution*

In the absence of any factors which would tend to create a greater market demand for the conversion security than for the convertible security, and thereby produce a concomitant differential in price, it seems evident that in most situations there is no possible speculative advantage to be achieved by a conversion and subsequent sale of the underlying common stock.[45] Therefore, under *Ferraiolo*'s "any possibility of abuse" test, it is relevant to consider whether the intermediate conversion itself might produce such a change in the economic position of the security holder that he could be regarded as having taken a profit on his investment.

In this respect, it should be noted that if the convertible security is not protected by an anti-dilution provision, it may be possible, in certain circumstances, for an insider with knowledge of the corporation's affairs to effect a conversion which will substantially improve his economic position. Protection against dilution ensures a constant conversion ratio between a convertible security and the underlying common stock.[46] If the number of outstanding common shares is altered, the number of common shares for which one convertible security may be exchanged increases or decreases proportionally. For this reason, anti-dilution provisions are commonly incorporated in convertible debentures and shares of convertible preferred stock.[47] In the absence of such protection for the holders of convertible securities, it is obvious that inside knowledge that a stock split or stock dividend is imminent would present an opportunity for abuse since insiders could convert their holdings prior to the split or the date of record for the dividend, and thus participate in the increase in the number of common shares.

Similarly, there is one additional situation in which a holder of a dilutable issue of convertible securities might profit, even without the advantage of inside information, by converting and selling the

45. See Blau v. Max Factor & Co., 342 F.2d 304, 308 (9th Cir.), *cert. denied*, 86 Sup. Ct. 180 (1965).

46. See Ferraiolo v. Newman, 259 F.2d 342, 345 (6th Cir. 1958), *cert. denied*, 359 U.S. 927 (1959).

47. See, *e.g.*, Heli-Coil Corp. v. Webster, 352 F.2d 156 (3d Cir. 1965); Ferraiolo v. Newman, *supra* note 46.

underlying common stock. If a convertible security does not contain an anti-dilution provision, it continually bears an overhanging threat that its value will be impaired by an increase in the supply of the conversion security. Although the effects of arbitrage[48] will normally prevent wide differences in price unfavorable to a dilutable issue, rumors of an impending split or stock dividend may nevertheless result in temporary differentials between the market prices of the two types of securities. The uncertainty as to the record date would cause most investors to be reluctant to purchase the convertible issue with a view toward conversion, but persons who already owned the convertible securities would be in a position to obtain a small profit by quickly converting and selling the more favored common stock.

In *Ferraiolo,* however, the court observed that the Ashland preferred was protected against dilution and was in that respect a mere substitute for the common into which it was convertible.[49] This theory was also vigorously relied upon by the defendant in *Heli-Coil,* since his convertible debentures contained a similar anti-dilution clause. Nevertheless, this indicium of the economic equivalence of the Heli-Coil common and debentures was completely ignored by the court. However, it would appear that since the Heli-Coil debentures were readily salable and fully protected against dilution, their market price would continue to be reflected accurately in the price of the common. Thus, since conversion of the non-dilutable debentures could not have produced a significant change in the economic position of the defendant bondholder, and since conversion offered no greater opportunity for profit than would a sale of the debentures themselves, the act of converting should not have been regarded as a "sale" of the convertible security or as a "purchase" of the underlying common stock.

2. *Marketability*

Many critics of the sweeping statements in the *Park & Tilford* opinion have suggested that the decision is at least correct on its own facts, since the convertible preferred was closely held and not readily marketable in the sense that it was not listed on an exchange or otherwise actively traded.[50] In an active market, convertible securities and the underlying common stock are normally traded at iden-

48. The term "arbitrage" refers to a specialized form of trading which is based upon disparities in quoted prices of the same or practically equivalent commodities and securities. By virtue of one form of such trading—kind arbitrage—the price disparity disappears as purchases of convertible securities are offset against sales of the conversion security. See Falco v. Donner Foundation, Inc., 208 F.2d 600, 603 (2d Cir. 1953); 2 Loss, *op. cit. supra* note 4, at 1108 n.276.

49. See 259 F.2d at 345.

50. See note 31 *supra.*

tical prices;[51] however, as the court in the *Park & Tilford* case noted, the private placement of large blocks of closely held convertible preferred stock is certain to have a depressing effect on its price.[52] Although this adverse effect could be mitigated by spreading the sales over a long period of time, such an approach would also involve the obvious risk that the demand for, and therefore the price of, the underlying common might decline, thus reducing the value of the convertible security as well. For this reason, the insiders in *Park & Tilford* could engage in market speculation on a large scale only after acquiring the underlying common, which was actively traded on the New York Stock Exchange.[53]

The ease with which widely held, actively traded securities may be sold in the market presents a compelling argument in favor of the "economic equivalency" found in *Ferraiolo*, where both securities were equally marketable and were traded at identical prices.[54] In such circumstances, no speculative opportunity can be gained by holding the common which does not also inhere in the possession of the convertible preferred. Conversion in this situation is not a liquidation of the original investment, but rather a deferment of accrued profits. An insider can secure the same benefit by choosing not to convert and instead selling his original (convertible) securities.[55]

Although the convertible debentures in *Heli-Coil* were unlisted, the court proceeded upon the basis that they were, nevertheless, actively traded over the counter.[56] Relying on this fact and the precedent of *Ferraiolo*, the defendant asserted that his conversion created no opportunity for new speculation.[57] The court conceded the relevance of this argument but nevertheless felt bound to follow an arbitrary rule of thumb that precluded all consideration of the circumstances underlying the transaction—even those which negated the existence of an opportunity to use inside information. However, since abuse of confidential information was the factor which prompted the enactment of section 16(b), it appears that the court's refusal to consider the equal marketability of the two Heli-Coil

51. See note 29 *supra* and accompanying text.

52. 160 F.2d at 990.

53. In an effort to distinguish the *Park & Tilford* decision, the district court in the *Ferraiolo* case pointed out that the *Park & Tilford* speculators had "to have common stock, which sold on the New York Stock Exchange, before they could hope to reap a quick profit." Ashland Oil & Ref. Co. v. Newman, 163 F. Supp. 506, 507 (N.D. Ohio 1957), *aff'd sub nom.* Ferraiolo v. Newman, 259 F.2d 342 (6th Cir. 1958).

54. *But see* Meeker & Cooney, *supra* note 33, at 963.

55. See Blau v. Max Factor & Co., 342 F.2d 304, 308 (9th Cir.), *cert. denied*, 86 Sup. Ct. 180 (1965); Ferraiolo v. Newman, 259 F.2d 342 (6th Cir. 1958), *cert. denied*, 359 U.S. 927 (1959).

56. 352 F.2d at 156.

57. Brief for Appellant, pp. 10, 15-17, Heli-Coil Corp. v. Webster, 352 F.2d 156 (3d Cir. 1965).

securities is inconsistent with its observation that the decision "must turn on the basic purpose of the statute."[58]

3. *Motivation*

Although the courts have devoted considerable attention to the perplexing problem of whether anti-dilution provisions and ease of marketability render two securities "economic equivalents," the principal judicial concern has been in regard to the significance that should be attributed to the element of volition in conversions and similar transactions.[59] The courts and commentators have generally felt that when an insider converts his securities after an unanticipated call for redemption of the convertible security, the transaction has in effect been "forced" by the corporate issuer, and therefore no liability should be imposed under section 16(b).[60] The fullest development of this view appears in the *Ferraiolo* case, where the conversion was clearly precipitated by the independent action of the issuing corporation. The court observed that the defendant was merely a passive director and that he was not in fact privy to any inside information concerning the company.[61] Thus, he could not have been expected to prevent or rescind the call of the convertible preferred. Moreover, since the market price of Ashland common was nine dollars above the redemption price of the convertible preferred, permitting their preferred stock to be redeemed was not a realistic alternative for the shareholders. The court conceded that the defendant could have avoided the loss by outright sale of the preferred on the open market, but stated that "it can hardly be said that a failure to sell is tantamount to a purchase."[62]

The wisdom of the court's conclusion in *Ferraiolo* that a forced conversion should not be regarded as a sale is also supported by the fact that when an insider is faced with an uncontrollable redemption call for his convertible securities at a price below the prevailing

58. 352 F.2d at 164.

59. See, *e.g.*, Blau v. Lehman, 286 F.2d 786 (2d Cir. 1960), *aff'd*, 368 U.S. 403 (1962); Ferraiolo v. Newman, 259 F.2d 342 (6th Cir. 1958), *cert. denied*, 359 U.S. 927 (1959); Roberts v. Eaton, 212 F.2d 82 (2d Cir.), *cert. denied*, 348 U.S. 827 (1954); Blau v. Mission Corp., 212 F.2d 77 (2d Cir.), *cert. denied*, 347 U.S. 1016 (1954); Shaw v. Dreyfus, 172 F.2d 140 (2d Cir.), *cert. denied*, 337 U.S. 907 (1949); Park & Tilford v. Schulte, 160 F.2d 984 (2d Cir.), *cert. denied*, 332 U.S. 761 (1947); Blau v. Lamb, 242 F. Supp. 151 (S.D.N.Y. 1965); Blau v. Lamb, 163 F. Supp. 528 (S.D.N.Y. 1958); Blau v. Hodgkinson, 100 F. Supp. 361 (S.D.N.Y. 1951).

60. See, *e.g.*, Ferraiolo v. Newman, 259 F.2d 342 (6th Cir. 1958), *cert. denied*, 359 U.S. 927 (1959); Park & Tilford v. Schulte, 160 F.2d 984 (2d Cir.), *cert. denied*, 332 U.S. 761 (1947); Blau v. Lamb, 163 F. Supp. 528 (S.D.N.Y. 1958); 2 Loss, *op. cit. supra* note 4, at 1068; Note, 72 HARV. L. REV. 1392 (1959). *But see* the counterargument in Heli-Coil Corp. v. Webster, 352 F.2d 156, 165 (3d Cir. 1965); Note, 107 U. PA. L. REV. 719, 724 (1959).

61. See 259 F.2d at 344.

62. *Id.* at 346.

market value of the underlying stock, conversion may be the only alternative that does not represent a substantial detriment to him. One example of this would be a situation in which an insider who has received notice of a redemption call desires to maintain his equity interest in the issuer. Obviously, the only two means by which he could achieve his objective would be either to convert to the underlying common stock (the course adopted by the defendant in *Ferraiolo*) or to sell his convertible securities and then purchase an equivalent amount of the company's stock in the market. It should be noted, however, that the latter method may involve a substantial risk of incurring liability under the act in a falling market. In this respect, although section 16(b) is not concerned with profits obtained from transactions in two independent classes of securities issued by the same corporation,[63] it is arguable that any two issues of securities, such as convertibles and the underlying common, which are so related as to afford a means of achieving in-and-out trading profits, are included within the scope of the act.[64] On the basis of this reasoning, if an insider sells his convertible securities to avoid the redemption and then repurchases the underlying security within six months at a lower market price, he would be subject to liability, since the statute encompasses profits from "sales and purchases" as well as "purchases and sales."[65] Thus, if an insider were content with his investment in the issuer, it would be unrealistic to expect him to sell his convertible securities with a view toward immediately reacquiring a proportionate interest in the conversion security.

Tax considerations offer a second basis for concluding that it would be inequitable to require insiders, in order to avoid liability under section 16(b), to sell convertible securities which have been called for redemption. In this regard, it is evident that a forced sale at a profit would necessitate payment of capital gains taxes[66] in the year the redemption call is issued, thus depriving an insider of the opportunity to incur tax liability at the time most convenient for him. Indeed, the foregoing considerations are so compelling that in the *Ferraiolo* case the owners of more than ninety-nine per cent of the Ashland preferred elected to convert.[67] Finally, from the standpoint of the issuer's own interests, holding that a truly forced conversion is subject to the provisions of section 16(b) might result in

63. Smolowe v. Delendo Corp., 136 F.2d 231, 237 n.13 (2d Cir.), *cert. denied*, 320 U.S. 751 (1943).

64. See 2 Loss, *op. cit. supra* note 4, at 1059; Rubin & Feldman, *supra* note 2, at 486.

65. 48 Stat. 896 (1934), 15 U.S.C. § 78p(b) (1964).

66. A subsidiary argument made by the defendant in *Heli-Coil* was that since conversion is not a taxable event, it should not be considered a "sale." Brief for Appellant, p. 6, Heli-Coil Corp. v. Webster, 352 F.2d 156 (3d Cir. 1965).

67. See 259 F.2d at 345.

drying up a potential source of capital. If every conversion involved both a purchase of the underlying common stock and a sale of the convertible security, no insider could ever buy convertibles in the market without assuming the risk that a forced conversion within the ensuing six months would render him liable for any profit realized.[68]

When the insider acts on his own volition, however, none of these consequences are forced upon him, and the courts have been much more inclined to impose liability under section 16(b). For instance, the defendants in the *Park & Tilford* case had argued that since they converted in response to a redemption call, their act was involuntary and could not have been motivated by privileged information. The court responded that any notion of a "forced" conversion was somewhat absurd in light of the fact that the defendants' control of the issuing corporation was so pervasive that they could have prevented the passage of the redemption resolution.[69] Judge Clark pointed out that the Schulte group had made a routine business decision as to the most profitable of the three possible courses of action—redemption, conversion and sale of the underlying common stock, or outright sale of the convertible preferred[70]—but did not offer any explanation as to how such conduct contravened the objectives of the statute.

This somewhat mechanical approach to voluntary transactions was also evidenced in *Blau v. Hodgkinson*.[71] The court concluded that the receipt of stock in a parent corporation in exchange for stock in a subsidiary pursuant to a plan of reorganization constituted a "purchase" where the defendant insider had an option to receive cash instead. The opinion clearly indicates that the exchange would not have been subject to section 16(b) if the defendant had been irrevocably bound to accept the parent corporation stock.[72] The broad implications of *Park & Tilford* are even more apparent in *Blau v. Lamb*,[73] in which the plaintiff attempted to match a conversion with a prior purchase of preferred stock. Although the judge denied motions by both parties for summary judgment, he stated: "I do not think that the defendants have established as a matter of law that the conversion of their preferred into common was not a sale. The fact remains that the conversion of the preferred was voluntary and that the common which was acquired through the conversion was publicly held."[74] In similar fashion, Judge Medina,

68. See 2 Loss, *op. cit. supra* note 4, at 1068.
69. 160 F.2d at 988.
70. *Ibid.*
71. 100 F. Supp. 361 (S.D.N.Y. 1951).
72. *Id.* at 373.
73. 163 F. Supp. 528 (S.D.N.Y. 1958).
74. *Id.* at 533. In the subsequent trial of the issues, it was held that the conversion

writing the opinion in a recent Second Circuit case, concluded that where an exchange of stock is "in all respects voluntary," the situation could lend itself to insider manipulation and to the making of short-swing profits within the meaning of the statute.[75] Again, no discussion was offered to explain the manner in which *unfair* profits could be made in the context of this particular conversion transaction.

Although the foregoing decisions largely fail to illuminate their *ratio decidendi*, it is apparent that their accumulated impact is substantial. Thus, when the district court in the *Heli-Coil* case emphasized the voluntary nature of the transaction[76] and minimized the defendant's argument that the securities in question were "economic equivalents," the decision was buttressed by considerable authority.

Nevertheless, a voluntary exchange of securities does not automatically lead to liability. In *Roberts v. Eaton*[77] the defendant insider, who owned 45.9 per cent of the outstanding common stock of Old Town Corporation, requested and obtained stockholder approval to convert all of the corporation's stock into a more marketable form. The newly created securities were subsequently sold within six months of the exchange. It was held that the combined effect of full disclosure of the proposed reclassification, equal treatment of all stockholders,[78] and maintenance of defendant's proportionate interest immediately after the transaction precluded the possibility of unfair use of confidential information. The clear implication of the *Eaton* decision is that even in voluntary exchanges the insider may be permitted to rid himself of liability, provided he can marshal sufficient evidence negating any inference that the transaction is an integral step in a scheme to exploit inside knowledge[79] or to stimulate market activity.[80]

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of preferred stock into common was a "sale." Blau v. Lamb, 242 F. Supp. 151 (S.D.N.Y. 1965). In this decision, the court emphasized the fact that the transaction was completely voluntary. *Id.* at 157.

75. Blau v. Lehman, 286 F.2d 786, 792 (2d Cir. 1960), *aff'd without consideration of this point*, 368 U.S. 403 (1962). *Accord*, B. T. Babbitt, Inc. v. Lachner, 332 F.2d 255, 258 (2d Cir. 1964) (dictum).

76. See Heli-Coil Corp. v. Webster, 222 F. Supp. 831, 835 (D.N.J. 1963). On appeal, the Court of Appeals for the Third Circuit regarded the lack of compulsion in the transaction as an element of "some importance," but the court preferred to rest its decision on a "rule of thumb." 352 F.2d 156, 167 (3d Cir. 1965).

77. 212 F.2d 82 (2d Cir.), *cert. denied*, 348 U.S. 827 (1954).

78. Nonpreferential treatment was also considered to be an important factor in the *Ferraiolo* case. See Ferraiolo v. Newman, 259 F.2d 342, 346 (6th Cir. 1958), *cert. denied*, 359 U.S. 927 (1959). *But see* Note, 107 U. PA. L. REV. 719, 723 (1959).

79. *Cf.* Blau v. Max Factor & Co., 342 F.2d 304, 308 (9th Cir.), *cert. denied*, 86 Sup. Ct. 180 (1965).

80. Unusual market activities by insiders are regarded in the investment community as indications of management's appraisal of the corporation's future prospects and

In summary, it appears that although the courts purport to be strictly enforcing section 16(b) in all exchanges of stock, in practice some courts have adopted a rebuttable presumption of liability whenever the conversion is truly voluntary. Although the defendant's burden of proof is onerous, it is nevertheless possible to prevent "harsh and wooden results quite unnecessary to achieve the purposes of the act."[81] However, it is evident from a comparison of the results in *Park & Tilford* and *Heli-Coil* with those in *Eaton* that to be persuasive, the exculpatory evidence must go to the peculiar circumstances of the transaction—such as full disclosure and stockholder approval[82]—rather than a general theory of "economic equivalence." Indeed, it must be conclusively demonstrated that neither the other owners of the convertible securities nor the holders of the common stock have been injured by the conversion.[83]

D. *Objective Measure of Proof*

The language of section 16(b) clearly indicates that Congress intended to permit recovery after short-swing transactions even though an insider may have initially acquired his securities for long-term investment purposes, but was subsequently forced to sell because of changed circumstances.[84] The need for this objective measure of proof was graphically illustrated by Thomas Corcoran, chief spokesman for the proponents of the act, when he stated:

> You hold the director, irrespective of any intention or expectation to sell the security within 6 months after, because it will be absolutely impossible to prove the existence of such intention or expectation, and you have to have this crude rule of thumb, because you cannot undertake the burden of having

can precipitate violent fluctuations in the price of the stock. See Meeker & Cooney, *supra* note 33, at 978; Comment, 69 YALE L.J. 868 (1960).

81. See Blau v. Mission Corp., 212 F.2d 77, 80 (2d Cir.), *cert. denied*, 347 U.S. 1016 (1954).

82. It should be noted, however, that stockholder approval alone will not overcome the presumption of unfairness associated with a conversion and quick sale of the underlying security. *Cf.* Magida v. Continental Can Co., 231 F.2d 843 (2d Cir.), *cert. denied*, 351 U.S. 972 (1956); Perlman v. Timberlake, 172 F. Supp. 246 (S.D.N.Y. 1959).

83. See Ferraiolo v. Newman, 259 F.2d 342 (6th Cir. 1958), *cert. denied*, 359 U.S. 927 (1959); Roberts v. Eaton, 212 F.2d 82, 83 (2d Cir.), *cert. denied*, 348 U.S. 827 (1954); *cf.* Shaw v. Dreyfus, 172 F.2d 140, 142 (2d Cir.), *cert. denied*, 337 U.S. 907 (1949).

84. "[A]ny profit realized by him [the insider] from any purchase and sale, or any sale and purchase, of any equity security of . . . [the] 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." 48 Stat. 896 (1934), 15 U.S.C. § 78p(b) (1964).

to prove that the director intended, at the time he bought, to get out on a short swing.[85]

Although the "crude rule of thumb" was instituted for the limited function of obviating the need to prove actual use of inside information, its purpose seems to have been misconstrued by the Third Circuit in *Heli-Coil.* Indeed, the court felt that this inflexible rule foreclosed all inquiry into facts indicating that it would have been impossible for Webster to exploit inside knowledge.[86] The confusion seems to stem from an assumption that the "rule of thumb" urged by Mr. Corcoran and the "possibility of abuse" test adopted by the courts are mutually exclusive concepts. However, the statutory history of the act makes it clear that the function of the "rule of thumb" is merely to eliminate the prohibitory burden of establishing an insider's intent. The "possibility of abuse" test, on the other hand, is related to the broader objective of determining whether a particular transaction even permits the unfair use of inside information. It seems apparent that the remedial purpose of the act would not be jeopardized by applying these concepts concurrently.[87] Moreover, it is manifest that the mechanical approach of holding an apparently innocuous conversion to be a purchase or sale is largely a judicial technique to lengthen the six-month limitation period set forth in the statute. Thus, since the procedure of converting preferred or debentures and then selling the underlying security is merely an alternative method of disposing of the convertible security, the rule adopted in *Heli-Coil* had the effect of penalizing the insider for doing indirectly what it was conceded he could have done directly over the eight-month period which had elapsed.[88]

II. The Good-Faith Debt Exception

A second aspect of section 16(b) that has received much less attention than the elusive definitions of "purchase" and "sale" is the express exception for good-faith debts. Notwithstanding the fact that profits have been realized from short-swing transactions, the insider may still escape liability if the securities in question were

85. *Hearings on S. Res. 84, and S. Res. 56 & 97, supra* note 2, at 6557.

86. See 352 F.2d at 164-65.

87. It should be noted that in addition to lacking support in the statute, the use of the "rule of thumb" theory in *Heli-Coil* is also contrary to the expressions in other recent conversion cases. For instance, Judge Medina recently stated that "while we held the transaction not to be a 'purchase' in Roberts v. Eaton, . . . the same line of reasoning was used. What was done in that case did not lend itself to the furtherance of the prohibited purpose. There is no rule of thumb; nor would it be wise to attempt to formulate such a rule." Blau v. Lehman, 286 F.2d 786, 792 (2d Cir. 1960), *aff'd,* 368 U.S. 403 (1962). *Accord,* Blau v. Max Factor & Co., 342 F.2d 304 (9th Cir.), *cert. denied,* 86 Sup. Ct. 180 (1965). *But see* 2 Loss, *op. cit. supra* note 4 (Supp. 1962, at 33).

88. *Cf.* Blau v. Max Factor & Co., *supra* note 87, at 308-09.

acquired in good faith in connection with an antecedent debt.[89] Whether the profits from a particular purchase and sale qualify for the exemption is essentially a question of the bona fides of the transaction.[90] Thus, whereas the over-all design of section 16(b) is based upon a strict objective measure of proof which proscribes all inquiry into the intent underlying an insider's conduct,[91] the good-faith debt exception expressly incorporates a subjective standard which permits an examination into the reason for accepting securities in discharge of a debt.[92] For many years it was felt that this good-faith test required a showing that it was absolutely necessary to take the securities in payment.[93] However, in a recent decision it was pointed out that it would be unreasonable to interpret the statute as confining the exemption to unusual situations where there is a complete lack of choice on the part of the creditor.[94] Instead, the element of choice should simply be recognized as one of the factors to be weighed in determining the insider's good faith.[95]

A. *Situations in Which the Exception Is Applicable*

The debt exception constituted a minor point of construction in the early case of *Smolowe v. Delendo Corp.*,[96] where one defendant insider acquired company stock which he used within a six-month period to repay a debt owing to a second insider. Although the phrase "acquired . . . in connection with" seems to be broad enough to encompass the payment of debts by delivering stock, the court felt that the adoption of such an interpretation would defeat the purpose of the exception, since profits otherwise recoverable under the statute could be washed out by the simple expedient of borrowing money which could be repaid in appreciated stock.[97] The court therefore refused to apply the good-faith debt exception on behalf of the first (debtor) insider, but, on the other hand, did hold that the stock received by the second insider in satisfaction of a bona fide debt could be disposed of at any time without liability.[98] It is

89. 48 Stat. 896 (1934), 15 U.S.C. § 78p(b) (1964).

90. See Rheem Mfg. Co. v. Rheem, 295 F.2d 473, 476 (9th Cir. 1961); Rubin & Feldman, *Statutory Inhibitions Upon Unfair Use of Corporate Information by Insiders*, 95 U. PA. L. REV. 468, 487 (1947).

91. See text accompanying notes 84 and 85 *supra*.

92. Rheem Mfg. Co. v. Rheem, 295 F.2d 473 (9th Cir. 1961). See Note, 1962 DUKE L.J. 589, 593; Note, 23 U. PITT. L. REV. 1020, 1021 (1962).

93. See Perlman v. Timberlake, 172 F. Supp. 246, 255 (S.D.N.Y. 1959) (dictum); Cook & Feldman, *Insider Trading Under the Securities Exchange Act*, 66 HARV. L. REV. 612, 632-33 (1953); Rubin & Feldman, *supra* note 90, at 487.

94. See Rheem Mfg. Co. v. Rheem, 295 F.2d 473, 477 (9th Cir. 1961).

95. *Ibid.*

96. 136 F.2d 231 (2d Cir.), *cert. denied*, 320 U.S. 751 (1943).

97. See *id.* at 239.

98. *Ibid.*

obvious that a contrary interpretation would deprive the lender in such a situation of the full benefit of repayment.

The only other decision which has applied the debt exception is *Rheem Manufacturing Co. v. Rheem*,[99] where the clause received its most thorough consideration to date. Pursuant to the issuer's retirement plan, which provided a choice among insurance, annuities, cash, and company stock, defendant Rheem elected to receive his benefits in the form of stock. For accounting purposes, the company issued Rheem a check for the amount of his interest in the plan, and he in turn gave his personal check for the number of shares nearest in value to this interest. Shortly thereafter, he pledged the shares with a bank to secure a prior debt. Just before the expiration of the six-month period following these transactions, the pledgee bank began selling the shares through a broker in order to liquidate the indebtedness. The court held that Rheem was not liable for the profits realized from these sales, since his employer had an unconditional obligation to pay a fixed sum quite apart from the form of the settlement by the stock transfer.[100]

B. *The Conversion Cases*

In contrast to the foregoing decisions, insiders in conversion cases have never succeeded in convincing the courts that a conversion security was received in connection with an antecedent debt. In the context of *Park & Tilford*, this result is easily justified. Neither preferred stock nor a conversion clause in such stock in any way constitutes a debt obligation. Instead, the preferred merely represents an interest in the equity and profits of the issuer, and the convertible feature grants the holder an option to select one form of ownership in lieu of another.[101]

The rationale of *Park & Tilford*, however, does not necessarily preclude application of the debt exception to convertible bonds, which are, in fact, debt obligations of the issuing corporation. In the *Heli-Coil* case, for example, the indenture agreement specifically stated that the bonds constituted an unconditional promise on the part of the issuing corporation to pay a definite sum of money, plus annual interest of five per cent.[102] Thus, when the bonds were converted and the underlying common stock acquired, the issuer's debt obligation to the defendant was extinguished.

99. 295 F.2d 473 (9th Cir. 1961). The case is discussed in Note, 1962 DUKE L.J. 589; 23 U. PITT. L. REV. 1020 (1962).

100. 295 F.2d at 476.

101. See Park & Tilford, Inc. v. Schulte, 160 F.2d 984, 987 (2d Cir.), *cert. denied*, 332 U.S. 761 (1947). The exception is obviously limited to securities acquired in payment of an actual debt. See Blau v. Ogsbury, CCH FED. SEC. L. REP. ¶ 90635 (S.D.N.Y. 1953), *aff'd*, 210 F.2d 426 (2d Cir. 1954) (no consideration given to the good-faith debt exception on appeal); Kogan v. Schulte, 61 F. Supp. 604 (S.D.N.Y. 1945).

102. 352 F.2d at 158.

Although it might appear that the good-faith debt exception should therefore be applicable to this situation, there are several reasons for not allowing insiders holding convertible bonds to make use of it. In the first place, it is somewhat misleading to characterize a convertible bond as representing only a debt obligation. In fact, a convertible bond is a composite of two distinct elements: a debt obligation and a speculative option permitting the holder to share in any market appreciation which may result from enhanced earnings prospects.[103] Thus, convertible bonds cannot meet the test announced in *Rheem*, which requires the existence of an obligation prior to and apart from the settlement that occurs when the stock is transferred.[104] As the court noted in the *Heli-Coil* case, a contrary interpretation would permit widespread abuse of section 16(b), since nearly all acquisitions of stock can take the form of a contract in which the seller owes a debt in the form of an obligation to deliver the stock at some future time, and in which the buyer has a corresponding obligation to pay for the stock in money or other property.[105] Moreover, a determination that convertible bonds are not to be treated as ordinary debts also appears to be consistent with the over-all design of the Securities Exchange Act, since the statutory definition of equity securities explicitly includes debentures which may be converted to common stock.[106]

A final consideration which suggests that convertible bonds should not be permitted to come within the good-faith debt exception relates to the observation in the *Rheem* case that this exemption was merely intended to make possible the "one-shot settlement of matured debts."[107] With convertible bonds it is quite clear that there is no matured debt prior to the due date specified in the indenture agreement. Furthermore, the features of redemption and convertibility totally preclude the generally accepted concept of a matured debt.[108]

III. Conclusion

The all-encompassing interpretations to which the broad language of section 16(b) quite naturally lends itself have been a source of disquietude since the inception of the Securities Exchange Act.[109] Nevertheless, Congress manifestly intended to deter insider abuse, and the courts have demonstrated a sense of responsibility in effect-

103. See generally 1 Dewing, Financial Policy of Corporations 269 (5th ed. 1953).

104. See Rheem Mfg. Co. v. Rheem, 295 F.2d 473, 476 (9th Cir. 1961).

105. 352 F.2d at 169. *Accord*, Varian Associates v. Booth, 224 F. Supp. 225, 227 (D. Mass. 1963), *aff'd*, 334 F.2d 1 (1st Cir. 1964), *cert. denied*, 379 U.S. 961 (1965).

106. 48 Stat. 884 (1934), 15 U.S.C. § 78c(a)(11) (1964).

107. 295 F.2d at 476.

108. See Heli-Coil Corp. v. Webster, 222 F. Supp. 831, 836 (D.N.J. 1963), *aff'd*, 352 F.2d 156 (3d Cir. 1965).

109. See generally Yourd, *Trading in Securities by Directors, Officers and Stockholders: Section 16 of the Securities Exchange Act*, 38 Mich. L. Rev. 134 (1939).

ing this policy, even to the extent of consciously imposing a "crushing liability" to serve as a deterrent.[110] Indeed, even though the Securities and Exchange Commission has exercised its expert judgment in certain instances and determined that various transactions present little possibility for abuse relative to the legitimate function they serve,[111] the courts have nevertheless invalidated these exemptions if they provide any conceivable unfair advantage.[112] This rather inflexible administration of an admittedly arbitrary statute[113] has given rise to frequent and severe criticism.[114]

It has recently been suggested, however, that the Procrustean approach manifested in earlier decisions is now largely a historical phenomenon.[115] In particular, there seems to be an increasing tendency to scrutinize the interrelated facts of exchange and conversion cases,[116] which have traditionally involved the greatest conceptual difficulties in applying the terms "purchase" and "sale." In fact, prior to *Heli-Coil*, it appeared that the courts had completely departed from the sweeping rule of liability originally advanced in the *Smolowe* case and reiterated in *Park & Tilford*. Although the *Heli-Coil* court was certainly correct in its thesis that the remedial purposes underlying section 16(b) require a strict, objective standard of proof, it does not follow that Congress intended the administration of the statute to be purely mechanical in every respect. Indeed, the weight of authority clearly indicates that the approach must be pragmatic, not technical,[117] and it should be noted that the *Heli-Coil* court did adopt a pragmatic rationale for the consideration of the good-faith debt exception. It is to be hoped that the courts will continue to be attentive to an insider's demonstration of functional reasons why a particular voluntary transaction did not permit any possibility for abuse. As the dissent in *Heli-Coil* pointed out, the

110. See Gratz v. Claughton, 187 F.2d 46, 52 (2d Cir.), *cert. denied*, 341 U.S. 920 (1951).

111. Section 16(b) contains an exemption provision which states that: "This subsection shall not be construed to cover . . . any transaction or transactions which the commission by rules and regulations may exempt as not comprehended within the purpose of this subsection." 48 Stat. 896 (1934), 15 U.S.C. § 78p(b) (1964).

112. See Greene v. Dietz, 247 F.2d 689 (2d Cir. 1957); Colby v. Klune, 178 F.2d 872 (2d Cir. 1949); Perlman v. Timberlake, 172 F. Supp. 246 (S.D.N.Y. 1959).

113. See notes 84 and 85 *supra* and accompanying text.

114. See, *e.g.*, 2 Loss, Securities Regulation 1087-90 (2d ed. 1961); Halleran & Calderwood, *Effect of Federal Regulation on Distribution of and Trading in Securities*, 28 Geo. Wash. L. Rev. 86, 114 (1959).

115. See Painter, *The Evolving Role of Section 16(b)*, 62 Mich. L. Rev. 649, 678 (1964).

116. See Blau v. Max Factor & Co., 342 F.2d 304 (9th Cir.), *cert. denied*, 86 Sup. Ct. 180 (1965); Booth v. Varian Associates, 334 F.2d 1 (1st Cir. 1964), *cert. denied*, 379 U.S. 961 (1965); Ferraiolo v. Newman, 259 F.2d 342 (6th Cir. 1958), *cert. denied*, 359 U.S. 927 (1959); Blau v. Lamb, 242 F. Supp. 151 (S.D.N.Y. 1965).

117. See Ferraiolo v. Newman, 259 F.2d 342, 344 (6th Cir. 1958), *cert. denied*, 359 U.S. 927 (1959); Painter, *supra* note 115, at 661.

choice is between the majority's "rule of thumb" and "a rule of reason designed to achieve a result that is both just and respectful of the legislative language and intendment."[118]

W. Richard Keller

118. 352 F.2d at 173-74.