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CORPORATIONS-SECURITIES EXCHANGE ACT OF 1934-EQUITABLE PRINCIPLES AS A BAR TO SHORT SWING RECOVERY UNDER SECTION 16(b)

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CORPORATIONS—SECURITIES EXCHANGE ACT OF 1934—EQUITABLE PRINCIPLES AS A BAR TO SHORT SWING RECOVERY UNDER SECTION 16(b)—Plaintiff corporation, after receiving authority from the Corporation Commissioner of California, gave to its key employees including defendants (who were officers of the corporation) options to purchase certain stock of the plaintiff. The plan originated with the president of the corporation and the agreement took place at a time when the stock was unlisted. At no time subsequent to the stock being listed on a stock exchange did the plaintiff advise defendants of the short swing requirements that arose from listing. Plaintiff's purpose in granting the option was to retain the services of its key employees and to induce these employees to expend their best efforts in the corporation's interest. The president of the plaintiff corporation advised defendants that they should take up their options annually to achieve a tax advantage, and that they could get funds by selling the purchased stock. Defendants exercised their options and sold stock within a six month period, profiting thereby. At the demand of a stockholder (who was not such at the time of the agreement and who bought ten shares subsequent thereto) plaintiff brought suit to recover profits under section 16(b) of the Securities Exchange Act of 1934.[1] *Held,* plaintiff cannot recover. The declared purpose of section 16(b) is to prevent the use of inside information. Since the corporation initiated and set up the entire plan and assured defendants of its validity, the corporation is now estopped from recovering profits made in pursuance of this agreement from the defendants who acted in good faith. *Consolidated Engineering Corporation v. Nesbit,* (D.C. Cal. 1951) 102 F. Supp. 112.

[1] 48 Stat. L. 881 at 896 (1934), 15 U.S.C. (1946) §78p(b). Section 16(b) provides that any profit realized by a director, officer or major stockholder from a sale and purchase or a purchase and sale of the corporation's securities within a six month period shall inure to the corporation irrespective of the intent of such person to hold the security longer than the six month period.

Before 1934, American business practices, brought to light during congressional investigations incident to the passage of section 16(b) of the Securities Exchange Act of 1934, were such as demanded drastic action;[2] section 16(b) was considered to be the solution in so far as insiders' abuses were concerned.[3] Legal writers, relying on legislative history, have uniformly interpreted the section as allowing an automatic recovery of profits regardless of the intent of the profit-maker and despite any other extenuating circumstances.[4] It was not surprising, therefore, that when a defendant under a section 16(b) proceeding asserted the defense of good faith and fair dealing it was to no avail.[5] As compared to the disallowance of stockholders' suits against insiders for non-disclosure in some jurisdictions and the difficulty of proof in states allowing such suits,[6] the automatic recovery provisions of section 16(b) were regarded as a bold deviation from the common law.[7] The very objections of those who have contested the constitutional validity of section 16(b) have been based on its all-inclusive scope, embracing bona fide transactions as well as unfair uses of inside information by officers, directors and major stockholders.[8] In the principal case the court, after discussing the good faith of the defendants, pointed out the fact that the corporation initiated the plan and should not be allowed to recover. However, the purpose of section 16(b) is not to compensate the corporation for any injury inflicted but to prevent insiders from making profits in short term transactions.[9] The application of the doctrine of estoppel

[2] Report of Senate Committee on Banking and Currency on Stock Exchange Practices, S. Rep. 1455, 73d Cong., 2d sess. (1934); Hanna & Turlington, "Protection of the Public Under the Securities Exchange Act," 21 VA. L. REV. 251 at 276 (1935). But see WITHINGTON, SECURITIES AND EXCHANGE ACT OF 1934 ANALYZED 28 (1934).

[3] Report of the Senate Committee on Banking and Currency on Stock Exchange Practices, S. Rep. 1455, 73d Cong., 2d sess. 68 (1934).

[4] Tracy and MacChesney, "The Securities Exchange Act of 1934," 32 MICH. L. REV. 1025 at 1057 (1934); Yourd, "Trading in Securities by Directors, Officers and Stockholders: Section 16 of the Securities Exchange Act," 38 MICH. L. REV. 133 at 133, 134 (1939). Even those doubting the policy of passing such a stringent act are agreed as to its automatic features, this being their prime target: Seligman, "Problems under the Securities Exchange Act," 21 VA. L. REV. 1 at 5 (1934); WITHINGTON, SECURITIES EXCHANGE ACT OF 1934 ANALYZED 27 (1934).

[5] Smolowe v. Delendo Corporation, (2d Cir. 1943) 136 F. (2d) 231.

[6] STEVENS, CORPORATIONS, 2d ed., 690-699 (1949).

[7] Tracy and MacChesney, "The Securities Exchange Act of 1934," 32 MICH. L. REV. 1025 at 1057 (1934); Yourd, "Trading in Securities by Directors, Officers and Stockholders: Section 16 of the Securities Exchange Act," 38 MICH. L. REV. 133 (1939); Rubin and Feldman, "Statutory Inhibitions upon Unfair Use of Corporate Information by Insiders," 95 UNIV. PA. L. REV. 468 at 472 (1947); Smolowe v. Delendo Corp., supra note 5 at 236: "A subjective standard of proof, requiring a showing of actual unfair use of inside information, would render senseless the provisions of the legislation . . . and 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 rules of liability. . . ."

[8] Smolowe v. Delendo Corp., supra note 5 at 240; Gratz v. Claughton, (2d Cir. 1951) 187 F. (2d) 46 at 50; Rubin and Feldman, "Statutory Inhibitions upon Unfair Use of Corporate Information by Insiders," 95 UNIV. PA. L. REV. 468 at 494, 495 (1947).

[9] "The recovery under the statute smacks more of being in the nature of a penalty paid for having engaged in a forbidden transaction than of being compensation for an injury inflicted. For it is difficult to detail any certain injury to a corporation from the fact of

in this case seems to violate the public policy aspects of the legislation[10] and, if followed, throws open the door to an examination of each case on its facts to discover whether recovery is equitable or not. For a corporation to be able to estop itself from recovering short swing profits because it initiated the short term transaction is, to say the least, a novel innovation, and would tear the substance out of section 16(b). The automatic provisions of this section work to preclude discussion of the plaintiff's motives and conduct as well as the defendant's.[11] The operative history of section 16(b) indicates that the ends have justified the means.[12]

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active trading in its shares other than that in some ways the liquidity and veracity of the market for its shares might have been impaired." Yourd, "Trading in Securities by Directors, Officers and Stockholders: Section 16 of the Securities Exchange Act," 38 MICH. L. REV. 133 at 150 (1939).

10 It is doubtful whether estoppel even on technical grounds should be applied in a case where a public right is involved. EVEREST AND STRODE, LAW OF ESTOPPEL, 2d ed., 332, 333, 401, 402 (1907). It seems clear that section 16(b) was intended as public policy legislation. Report of the Senate Committee on Banking and Currency on Stock Exchange Practices, S. Rep. 1455, 73d Cong., 2d sess. 68 (1934).

11 Magida on behalf of Vulcan Detinning Co. v. Continental Can Co., (D.C. N.Y. 1951) 12 F.R.D. 74 at 78 (objections to the questions seeking to elicit facts of plaintiff's motive sustained); Yourd, "Trading in Securities by Directors, Officers and Stockholders: Section 16 of the Securities Exchange Act," 38 MICH. L. REV. 133 at 145 (1939).

12 Rubin and Feldman, "Statutory Inhibitions upon Unfair Use of Corporate Information by Insiders," 95 UNIV. PA. L. REV. 468 (1947). In discussing the merits of §16(b) the above authors at 502 point out: "It is no answer to assert that management generally will not trade on inside information. . . . An insider would be less than human were he not tempted by such information, and it is just such temptations that the law in the same or similar contexts has rigidly guarded against."