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Section 16(b) of the Securties Exchange Act of 1934 An Alternative to Burning Down the Barn in Order to kill the Rats

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SECTION 16(b) OF THE SECURITIES EXCHANGE ACT OF 1934: AN ALTERNATIVE TO "BURNING DOWN THE BARN IN ORDER TO KILL THE RATS"[1]

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The author critically analyzes Section 16(b) of the Securities Exchange Act of 1934. Though he agrees with the basic purpose of 16(b), the author criticizes the harsh manner in which it is often applied. He suggests that the provision's present inflexibility be removed by permitting the 16(b) defendant to exculpate himself with proof that he did not possess inside information. In explaining how this proposal could be implemented, the author also suggests that the Securities Exchange and Commission be vested with the responsibility for enforcing 16(b).

At one time profits from "sure thing" speculation by corporate insiders[2] were accepted as a usual emolument of office. However, this acceptance was swiftly changed by legislation in 1934. Congressional subcommittee hearings unearthed many examples of insiders who used their positions of trust and their consequent access to confidential information in order to aid themselves in market activities.[3] Section 16(b) of the Securities Exchange Act of 1934[4] was intended to correct these abuses. This section is relatively short, and its terms are simple and appear to be easily understandable.[5] The rationale of this section was evinced by

[1] The title is taken in part from the statement of Mr. George Rea, former President of the New York Curb Exchange (now the American Stock Exchange) that "This part of the law has, in truth, burned down the barn in order to kill the rats." Proposed Amendments to the Securities Act of 1933 and to the Securities Exchange Act of 1934, Hearings Before House Committee on Interstate and Foreign Commerce, 77th Cong., 1st Sess. 1249 (1941).

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[2] The word "insider" is used throughout this paper to include directors, officers, and ten per cent stockholders of any class of equity security of the issuer.

[3] One notorious example is that of the brothers who perpetrated the following fraud. Within a short time before the company passed a dividend, these brothers sold their stock for $16,000,000; after the news had become public, they repurchased an equivalent amount of stock for $7,000,000. S. Rep. No. 792, 73d Cong., 2d Sess. 9 (1934). See also S. Rep. No. 1455, 73d Cong., 2d Sess. 55 (1934).

[4] 48 Stat. 896 (1934), 15 U.S.C. § 78p(b) (1964) [hereinafter referred to as section 16(b)].

[5] 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

a statement made at the 1934 congressional hearings that 16(b) "is simply an application of an old principle of law that if you are an agent and you profit by inside information concerning the affairs of your principal, your profits go to your principal."[6] The corporation is provided with a means by which to recoup insiders' profits realized by a purchase and sale (or vice versa)within a six-month period.

The scope of 16(b) was recently enlarged for the first time since its passage.[7] Prior to the recent amendments, 16(b) was applicable only tc listed companies.[8] Now it is applicable to large over-the-counter companies as well.[9] In addition, some insurance companies, in attempting tc gain exemption from federal regulation under 16(b), may now find themselves subject to state regulation of insider trading.[10] And there is now a general exemption for over-the-counter-market making activities by dealers.[11]

There are several ways by which to discover violations. Section 16(a) requires reports to be filed. The proxy rules require disclosure in this area.[12] One may also find such disclosure in financial statements included in a registration statement or annual report filed by the issuer.[13] Finally, the SEC publishes the monthly "Official Summary of Security Transactions and Holdings" showing transactions which were reported during the month prior to publication.[14] The deterrent effects of these reporting requirements should not be underestimated.

No other country in the world has any effective legislation which

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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.

[6] Stock Exchange Regulation, Hearings on H.R. 7852 and 8720 Before the House Committee on Interstate and Foreign Commerce, 73d Cong., 2d Sess. 133 (1934) (Mr. Corcoran).

[7] For a general analysis of the Securities Acts Amendments of 1964, see Phillips & Shipman, "An Analysis of the Securities Acts Amendments of 1964," 1964 Duke L.J. 706.

[8] Securities Exchange Act of 1934 § 12(a), 48 Stat. 892, 15 U.S.C. § 78l(a) (1964).

[9] Securities Exchange Act of 1934 § 12(g), added by 78 Stat. 566-69 (1964), 15 U.S.C. § 78l(g) (1964); see generally Securities Exchange Act of 1934 § 16, 48 Stat. 896-97, as amended, 78 Stat. 579 (1964), 15 U.S.C. § 78p (1964).

[10] Securities Exchange Act of 1934 § 12(g)(2)(G), added by 78 Stat. 567 (1964), 15 U.S.C. § 78l(g)(2)(G) (1964).

[11] Securities Exchange Act of 1934 § 16(d), added by 78 Stat. 579 (1964), 15 U.S.C. § 78p(d) (1964). Many people feel that over-the-counter securities need a sponsor to make a market in them. The making of a market is often done by the original underwriter. The theory behind the 16(d) exemption is that it is necessary for the underwriter-sponsor to be a director of the company because he wishes to protect his customers who have purchased the stock and provide guidance to the inexperienced company. Thus, 16(b) is not applied to this situation. See Painter, "Section 16(d) of the Securities Exchange Act: Legislative Compromise or Loophole?" 113 U. Pa. L. Rev. 358 (1965).

[12] 17 C.F.R. § 240.14a-11 Sch. 14A, Item 7(e) (1964).

[13] 2 Loss, Securities Regulation 1043-44 (2d ed. 1961).

[14] See Meeker & Cooney, "The Problem of Definition in Determining Insider Liabilities Under Section 16(b)," 45 Va. L. Rev. 949 (1959).

operates in the same way as our 16(b).[15] The statute is even too radical for Castro's Cuba, which substantially adopted our 1933 and 1934 Acts but allows recovery under the Cuban 16(b) only upon proof of actual abuse of inside information.[16] In Japan, the only other country to have a 16(b) (and it adopted it only as a blessing of defeat after World War II), there has never been a suit under the statute.[17] The Jenkins Committee in England recommended 16(a) but not 16(b).[18] Furthermore, just last year an Ontario committee, after examining the United States' experience with 16(b), denounced the section vigorously.[19] All this seems surprising in light of the almost uniform approval of 16(b) expressed by the American writers on the subject. Thus, despite total support from abroad, one embarking on a critical analysis of 16(b) in this country is virtually breaking new ground.

It is almost trite to state these days that an insider owes a fiduciary duty to his company's stockholders.[20] *First*, only a lawyer who has become a slave to legal fictions could seriously argue that an insider has a duty to his corporation but not to the stockholders. *Second*, no legal fiction will justify the argument that an insider who sells to a person who is not already a stockholder is not a fiduciary. It would not be sound "to allow him to use the advantage of his position to induce the buyer into the position of a beneficiary, although he was forbidden to do so, once the buyer had become one."[21] Thus, in analyzing 16(b), one is compelled to concede the validity of its underlying premise, namely that the insider owes a fiduciary duty to his vendors and vendees alike.

However, despite the soundness of the underlying premise of 16(b), it would seem to be misdirected in its application to three large problem areas. *First*, the act seems to deal in an unnecessarily harsh way with the insider when it forbids him to defend his short-swing trading by showing, for example, that he did not possess any inside information. *Second*, the method of computation of profit which the courts have developed may force the insider to disgorge more than his "profit," as that term is understood in the lay sense. *Third*, the section creates problems of ethics for the lawyer when it orders that, by means of derivative suits, recovery

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15 See generally 2 Loss, Securities Regulation 1130-32 (2d ed. 1961).

16 Ley del Mercado de Valores y Bolsas, Ley Num. 498, Gaceta Oficial Aug. 24, 1959, 11 Leyes del Gobierno Provisional de la Revolucion 48 arts. 64, 65.

17 Securities and Exchange Law of Japan Ch. 8 art. 189 (1948), translated in EHS Law Bulletin Series—Japan.

18 Board of Trade, Report of the Company Law Committees §§ 89-99 (1962).

19 Province of Ontario, Report of the Attorney General's Committee on Securities Legislation in Ontario 2.28-2.29 (March 1965).

20 See, e.g., Guth v. Loft, Inc., 23 Del. Ch. 255, 270, 5 A.2d 503, 510 (Sup. Ct. 1939).

21 Gratz v. Claughton, 187 F.2d 46, 49 (2d Cir.) (L. Hand, J.), cert. denied, 341 U.S. 920 (1951).

be given to the company which has not been harmed by the insider's trading. The present structure of 16(b) is such that it encourages lawyers to institute enforcement actions for the purpose of receiving legal fees. After examining the "nature" of 16(b) and its application in a few hardship cases, this article will propose changes in each of these three areas.

I

THE NATURE OF 16(b)

A. *Predictability vs. Equity*

In one sense 16(b) and Rule 10b-5[22] are at opposite poles. Whereas 10b-5 is vague, general, and open to interpretation, 16(b) is specific, predictable, and arbitrary. In fact, one of the draftsmen of 16(b) recognized that his product was "a crude rule of thumb."[23] Yet there are many areas in which the lawyer cannot advise his client with certainty.[24] The following are some examples. Is a "divisional officer" an officer within the meaning of 16(b)? Which conversions or reclassifications or mergers or stock options involve purchases and sales? When does the purchase or sale take place? Can there be liability where there is a purchase of convertible preferred and a sale of common stock within a six-month period? Does 16(b) cover a director or officer who resigns after his purchase but prior to his sale? Is the acquisition of a call a purchase?[25] In light of these questions, it is worth asking whether the present 16(b) affords that degree of predictability which justifies a sacrifice of equity.

B. *Letting the "Fish" Escape*

In several areas of the law in which 16(b) provides predictability, it does so in an adverse way. It lets many "big fish" out of the net. If an

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[22] 17 C.F.R. § 240.10b-5 provides that:
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,
(a) To employ any device, scheme, or artifice to defraud,
(b) 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
(c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

[23] Testimony of Mr. Thomas C. Corcoran, Hearings on S. 97 Before the Senate Committee on Banking and Currency, 73d Cong., 2d Sess., pt. 15, at 6557 (1934). This has even been called the understatement of the 20th Century. Halleran and Calderwood, "Effect of Federal Regulation on Distribution of and Trading in Securities," 28 Geo. Wash. L. Rev. 86, 115 (1959).

[24] See Kramer, "An Examination of Section 16(b)," 21 Bus. Law. 183, 186 (1965).

[25] Miller v. General Outdoor Advertising Co., 337 F.2d 944 (2d Cir. 1964) (summary judgment for defendant reversed since this is first case presenting issue of whether acquisition of a call is a purchase).

insider holds his security for exactly six months, for example, there can be no recovery regardless of how much proof is adduced of unfair resort to inside information.[26] The morals of this kind of insider would seem no more worthy of approbation than those of his brethren who happen to sell one day earlier, and there is no reason to "reward" his cunning. Further, six months seems to have been an unfortunate selection for a cut-off date, since it plays into the hands of the insider who seeks the benefit of the advantageous capital gains tax rate.[27] The statutory holding period must be longer than six months if we are more effectively to deter the tax conscious insider.

Nor does section 16(b) reach the insider who only purchases or sells, even though admittedly on the basis of inside information. It extends only to those who engage in both a purchase and a sale within a six-month period. The failure of 16(b) to cover this situation has left us with three widely differing common law views on the subject,[28] a statutory limited protection for buyers only,[29] a general statutory anti-fraud provision which can be used against sellers alone and which is probably enforceable only by the Commission,[30] and the still uncertain and possibly over-extended remedy of Rule 10b-5.[31]

The case of the "tippee" is another problem area not reached by 16(b).[32] The insider's confidant (*query* as to his wife) can trade freely on a daily basis without any worry of 16(b). Early drafts of 16(b) made it unlawful for the insider to improperly disclose inside information and provided that the issuer could recover profits made by "tippees."[33] These

[26] See Babbit, Inc. v. Lachner, 332 F.2d 255 (2d Cir. 1964); Adler v. Klawans, 267 F.2d 840, 845 (2d Cir. 1959) (dictum); Brief for Appellants, Booth v. Varian Associates, 334 F.2d 1 (1st Cir. 1964).

[27] Int. Rev. Code of 1954, §§ 1222(3), 1201(b); see Adler v. Klawans, supra note 26; Painter, "The Evolving Role of Section 16(b)," 62 Mich. L. Rev. 649 (1964).

[28] See Strong v. Repide, 213 U.S. 419 (1909) (there is a duty of disclosure only in cases of "special circumstances"); Blazer v. Black, 196 F.2d 139 (10th Cir. 1952) (the "Kansas rule" is that a director negotiating with a shareholder, at least in the purchase of shares, acts in a relation of trust and confidence); Carpenter v. Danforth, 52 Barb. (N.Y.) 581 (Sup. Ct. 1868) (insiders are under no obligation to disclose as long as they do not actively mislead or falsify).

[29] Section 12(2) of the Securities Act of 1933. This provision has a short one-year period of limitations. Securities Act of 1933, § 13, 48 Stat. 84, as amended, 15 U.S.C. § 77m (1964). Also, the plaintiff buyer may be forced to post security for costs. The language of § 12(2) will reach cases of omission only where the courts are willing to imply a representation by the insider.

[30] Securities Act of 1933, § 17(a), as amended, 68 Stat. 686 (1954), 15 U.S.C. § 77q(a) (1964).

[31] For example, it should be noted that the Supreme Court has not as yet passed on the validity of private actions under Rule 10b-5. But cf. J. I. Case Co. v. Borak, 377 U.S. 426 (1964); Lowenfels, "Private Enforcement in the Over-the-Counter Securities Markets: Implied Liabilities Based on NASD Rules," 51 Cornell L.Q. 633, 644-47 (1966).

[32] See 3 Loss, Securities Regulation 1450-51 (2d ed. 1961).

[33] Hearings on H.R. 7852, H.R. 8720. Before the Committee on Interstate and Foreign Commerce, 73d Cong., 2d Sess. (1934); see Smolowe v. Delendo Corp., 136 F.2d 231, 236 (2d Cir. 1943), cert. denied, 320 U.S. 751 (1943).

provisions were omitted in the final draft of the section due to difficulties of proof. However, the "tippee" problem may not be too serious if Rule 10b-5 is interpreted to apply in this area.[34]

C. *Catching the "Minnows"*

In addition to letting some "big fish" escape, 16(b) also includes within its provisions some "minnows" whom in equity should not be covered. It will be profitable to examine a few sample areas in which 16(b) has been applied in a somewhat ruthless manner. Cases arise in which the company does not want to sue the insider or perhaps has even encouraged the insider to trade and has benefited therefrom. These are not defenses to the insider under 16(b).[35] In one case the defendant pleaded that he was induced to accept a position as director by plaintiff company's president and sole stockholder, who agreed to finance defendant's purchase of shares.[36] He further alleged that he sold his stock within the statutory period in order to repay his loan. The court rejected any such defense and refused to estop the plaintiff. In a case last year a company sent out a proxy statement to the effect that it would not sue a director for short-swing trading because he did not in fact abuse in any way his position as director and because he was not using for his own benefit any confidential information.[37] The court sustained a derivative suit even though the company had never been requested to sue, since the company had already in effect demonstrated its refusal to do so.

One more area in which 16(b) has been applied in at least an arguably harsh manner is the area of insiders who could have had access to information at only one end of the transaction. Such insiders have often been held liable. Stockholders have been held where it was the very purchase in issue which made them ten per cent holders.[38] Directors have been held where they had not even become directors until after their purchase.[39] Insiders have been held where the stock was not listed (under the pre-1964 test of coverage) at the time of purchase.[40] Although the

[34] Rule 10b-5, 17 C.F.R. § 240.10b-5, is set out in full at note 22 supra.

[35] See, e.g., Perlman v. Timberlake, 172 F. Supp. 246, 254 (S.D.N.Y. 1959) (it is no defense that the corporation gave full approval to the transaction); Blau v. Allen, 163 F. Supp. 702 (S.D.N.Y. 1958) (a desire to benefit the corporation is no defense); Magida v. Continental Can Co., 231 F.2d 843, 846-47 (2d Cir.), cert. denied, 351 U.S. 972 (1956) (even actual benefit to the corporation is no defense).

[36] Perfect Photo, Inc. v. Grabb, 205 F. Supp. 569 (E.D. Pa. 1962).

[37] Berkwich v. Mencher, 239 F. Supp. 792 (S.D.N.Y. 1965).

[38] See, e.g., Stella v. Graham-Paige Motors Corp., 232 F.2d 299 (2d Cir.), cert. denied, 352 U.S. 831 (1956) (note the dissent on this point by Hincks, J). The result in cases like Stella has been reached despite the language in 16(b) that it "shall not be construed to cover any transaction where such beneficial owner was not such both at the time of the purchase and sale . . . ."

[39] See, e.g., Adler v. Klawans, 267 F.2d 840 (2d Cir. 1959); Marquette Cement Mfg. Co. v. Andreas, 239 F. Supp. 962 (S.D.N.Y. 1965); Blau v. Allen, supra note 35.

[40] Perfect Photo, Inc. v. Grabb, supra note 36.

wording of the statute does not compel this interpretation, it is at least maintainable that 16(b) was intended to reach only those who had an inside position prior to both the short-term purchase and sale. Since, as we have seen, the act would not cover a director who merely sells stock,[41] it seems somewhat arbitrary to subject that same director to liability just because he had purchased stock before becoming a director and hence before gaining any possible access to inside information. The interpretation suggested here (*i.e.*, the possibility of covering only those insiders who are "in on both ends") would not allow a person to purchase a twenty per cent block, sell it out until his ownership was reduced to less than ten per cent, and then repeat the process, ad infinitum; courts would not tolerate such bad faith machinations.

Admittedly, some of the "in-on-only-one-end" insiders may well deserve the punishment which the courts mete out to them (*e.g.*, if they in fact abuse their trust on that end of the transaction). But the issue is whether such a result can be justified under the present structure of 16(b). Congress could rationally have preferred to leave a loophole in the act for those who deserve to be held accountable rather than to "suck into a suffocating dragnet many who . . . could not justly be held. . . ."[42] At any rate, whether we decide to reach the good and bad alike or to let them both escape, the insider who is only in on one end should be treated no differently than the insider who engages in only one transaction.

The recent case of *Booth v. Varian Associates*[43] presents a good example of the unduly harsh application of 16(b). Defendants Booth and McCarthy, the sole stockholders of Bomac Corporation, agreed with plaintiff Varian Associates to enter into a Class B reorganization (share for share exchange) for tax purposes. Booth and McCarthy sold eighty per cent of their shares of Bomac in return for Varian shares. Thereafter, they became directors of Varian. Later, on January 14, 1959, defendants agreed to sell plaintiff their remaining twenty per cent of Bomac in return "for that number of shares of plaintiff corporation which, on the basis of the market quotations of the day before closing (June 29, 1962), would equal in value $2,000,000 plus . . . ." Only Varian (for all practical purposes) was given the right to accelerate the closing date. Defendants sold their Varian stock within six months after the June 1962 closing date but, of course, more than six months after the January 1959

41 See text preceding note 28 supra.

42 Stella v. Graham-Paige Motors Corp., supra note 38, at 305 (Hincks, J., dissenting).

43 224 F. Supp. 225 (D.C. Mass. 1963), aff'd, 334 F.2d 1 (1st Cir. 1964), cert. denied, 379 U.S. 961 (1965). Much of the material concerning this case was taken from Professor Loss' Petition for Writ of Certiorari to the Court of Appeals.

contracting date. In a summary judgment the court required them to turn over their profits on the theory that the later closing date, and not the earlier date of contract, was the purchase date for purposes of 16(b).[44] The following factors seemed to persuade the court: (1) defendants had no investment position in the Varian stock and hence assumed no market risk during the years between 1959 and 1962; (2) the statute of limitations might have expired before profits could have been calculated if defendants had sold shares of Varian in 1959 and if the earlier date were selected as the proper purchase date under 16(b); (3) speculators generally cannot very well calculate the effects of their market transactions at a time when they lack such critical information as how much stock they are to receive and the price of each share.

This decision would appear to constitute a cavalier handling of an innocent transaction. Defendants had made a binding and irrevocable commitment in January 1959, despite the fact that the price per share and number of shares of Varian stock could not be determined until the fixed formula was applied on the closing date more than three years later. The court seemed to ignore the fact that the defendants could have profited in the short-term from possible inside information (of an unfavorable nature) by selling Varian certificates which they already possessed within six months of January 1959, whereas there could not have been abusive use of short-term information three and one half years after that date. In other words, defendants' lack of control over the closing date foreclosed their opportunity to make short-swing profits in 1962. As to the statute of limitations point, there should be no problem in tolling the statute until the profits can be calculated. Or it might be argued that since 16(b) explicitly provides for suits in equity, it would be appropriate for the court to enter a judgment for an accounting, the execution of which would await the arrival of the closing date. Furthermore, there is no danger of the embarrassing expiration of the two-year limitations period under the facts of *Booth* because there was no violation of 16(b) until the sale occurred in 1962.

The effect of the decision was to preclude any selling by defendants for three and one half years because they would be caught under 16(b) if Varian, within six months after any of their sales, decided to accelerate the closing date. The court stretched the six-month period into a three and one-half year period. Its decision recaptures a profit which could not possibly have resulted from the short-term use of information obtained on the closing date, the choice of which was beyond defendants' control. At the same time it precludes recapture of a short-term profit which might

[44] Booth v. Varian Associates, supra note 43.

have resulted from the use of inside information if there had been a sale within six months of the date of contracting (unless 16(b) is to be interpreted such that a defendant may be said to have "purchased" the same shares at two different times). Thus the *Booth* case clearly presents the twin dilemma of 16(b); it lets many "guilty" insiders escape while it catches many "innocent" ones.

Finally, this "parade of horrors" would be incomplete without reference to the possibility of double or even treble liability which threatens the insider. He might, for example, be held liable to both his vendor and vendee on the ground of misrepresentation or nondisclosure under Rule 10b-5, and then on top of these liabilities be held liable to the company under 16(b).[45] Professor Loss seems to feel that all three suits could succeed.[46]

D. *Application by the Courts of the Strict and Simple Terms of 16(b)*

Another problem engendered by the present nature of 16(b) is that, because its terms are inflexible to the point of being arbitrary, it causes so many hardship cases that, despite the announced policy of Congress, courts have sometimes had to bend its simple and rigid rules to avoid injustice. Further, because of the simple and inflexible language of the section, many situations are not precisely covered by 16(b), with the result that there is little predictability in many cases. These problems can be seen in several contexts.

1. *Law of Purchase and Sale*

Many times it is not clear whether a "purchase" or "sale" has in fact taken place. This problem is likely to arise in such situations as reclassifications, conversions, and intercorporate exchanges of stock. The test most often laid down by the courts in this area is whether the transaction in question could possibly lend itself to the speculation encompassed by 16(b).[47] To put it another way, the courts ask whether the circumstances of the particular case are such that, assuming the possession or use of inside information, the insider could have obtained any advantage over the public which he did not already possess. Thus, the courts do not

[45] Given the choice, an insider might fare better if the 10b-5 suit is brought before the 16(b) suit, rather than the other way around. He could then argue (query how successfully) that he has no more profit to turn over to the corporation; see Stevens, Corporations 702 (2d ed. 1949).

[46] 3 Loss, Securities Regulation 1473-74 (2d ed. 1961).

[47] See, e.g., Blau v. Max Factor & Co., 342 F.2d 304 (9th Cir. 1965), cert. denied, 382 U.S. 892 (1965); 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. 1954), cert. denied, 348 U.S. 827 (1954); Blau v. Lamb, 242 F. Supp. 151 (S.D.N.Y. 1965), rev'd, — F.2d — (2d Cir. 1966); cf. Heli-Coil Corp. v. Webster, 352 F.2d 156 (3d Cir. 1965); Park & Tilford, Inc. v. Schulte, 160 F.2d 984 (2d Cir.), cert. denied, 332 U.S. 761 (1947).

follow a rule that any one of these situations always will (or will not) produce a "purchase" or "sale." Instead they follow what may be called a "what might have been" approach.[48]

One of the most recent 16(b) cases, *Heli-Coil Corp. v. Webster*,[49] illustrates some of the problems which the courts now face in the purchase-sale area. For purposes of presentation, the facts will be simplified. In month #1 a director bought one convertible debenture at $10. In month #5, when the value of the debenture and one share of common stock was $20, the director converted his one debenture into one share of common stock. Finally, in month #10 the director sold his share of common stock at $30. The issue concerned the director's liability under 16(b).

The majority held that the conversion of the debenture was a sale of the debenture and a purchase of the common stock.[50] The court rejected the "what might have been" approach in favor of what it called the "crude rule of thumb" test, and the basis for its decision apparently was that it is the statutory purpose to reach all types of acquisitions and dispositions. This purpose, according to the court, is expressed in the broad definitions of "buy" and "sell" in subsections 3(a)(13) and 3(a)(14).[51] But despite its verbal rejection of the "what might have been" approach, the majority nevertheless noted that the decision to convert could have been induced by inside information, even though it may not in fact have been so motivated.

One of the dissenting positions agreed with the majority that the conversion was a sale of the debenture and a purchase of the stock. These judges saw the transaction as the equivalent of a cash sale of the debenture and a reinvestment of the cash in common stock. They parted company with the majority, however, when they concluded that not only should the defendant be held liable for the gain realized on the sale of the stock ($10) but also for the gain realized at the time of the conversion of the debenture ($10 more). Perhaps these judges found it difficult to understand how a purchase at $10 followed by a sale at the equivalent of $20 failed to result in a profit.

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48 Analogy may be made to the Rule Against Perpetuities. That rule states: "No interest is good unless it must vest, if at all, not later than twenty-one years after some life in being at the creation of the interest." Both the Rule Against Perpetuities and the test for a purchase or sale under 16(b) look to what might have happened. Yet, in the case of the Rule Against Perpetuities, the courts have come to realize that a "what might have been" approach can operate very harshly. Hence, through such doctrines as "Wait and See" and "Second Look" they have been moving toward substitution of a "what did happen" approach in place of the "what might have been" approach. It would seem that the same approach could be adopted in connection with liability under 16(b).

49 352 F.2d 156 (3d Cir. 1965), 19 Rutgers L. Rev. 151 (1964) (a discussion of the case and the lower court's opinion).

50 Heli-Coil Corp. v. Webster, 352 F.2d 156, 161 (3d Cir. 1965).

51 Ibid.

The second dissenting position stated that the conversion was neither a sale nor a purchase. These judges applied the "what might have been" test and found that the conversion in this case did not afford the defendant any opportunity to benefit from use of inside information. Their position was that, since more than six months had elapsed between the purchase of the convertible security and the sale of the equivalent security for which it had been exchanged, the director did not engage in the in-and-out trading that 16(b) seeks to prevent. Thus, there should be no recovery at all.

Cases such as *Heli-Coil*, in which some judges hold the defendant liable for a $10 profit, others would hold him for a $20 profit, and still others would not hold him at all, make one wonder where 16(b)'s simplicity, predictability, and objectivity have gone. It is apparent from the differing positions in the *Heli-Coil* case that in this area of purchase and sale there is a dispute as to whether the "what might have been" approach is preferable to the newly born and possibly challenging "crude rule of thumb" test which probably embraces most, if not all, conversions.

2. *The Insider Who Is a Partner of a Broker-Dealer Firm*

There is another area of 16(b) law in which the courts seem to have bent the firm wording of the statute. The situation arises when a partnership engages in short-term trading in a security, and one of the partners is a director of the company whose securities are so traded.

In *Blau v. Lehman*,[52] Lehman Brothers, an investment banking firm, had a partner Thomas, who was a director of Tidewater Oil Company. The partnership traded in the stock of Tidewater, but Thomas was not a member of the investment committee of the partnership. The issue of the case was whether Tidewater could recover from either Lehman or Thomas the full measure of Lehman's profit, or whether recovery was limited to the portion of partnership profits attributable to Thomas' interest in the partnership. The trial court found as a fact that the stock was bought and sold by the partnership without the advice or concurrence of Thomas and hence without any abusive use of inside information. One wonders why this finding was made (and reiterated by the Supreme Court) in view of the usual irrelevance of actual abuse under current law.[53]

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[52] 173 F. Supp. 590 (S.D.N.Y. 1959), aff'd, 286 F.2d 786 (2d Cir. 1960), aff'd, 368 U.S. 403 (1962), 37 Notre Dame Law. 538 (1962); see Ratner v. Lehman, 98 F. Supp. 1009 (S.D.N.Y. 1951), aff'd, 193 F.2d 564 (2d Cir. 1952).

[53] The reiteration of this finding by the Supreme Court is even more puzzling in light of Mr. Justice Black's view that 16(b) will not reach the "tippee." Blau v. Lehman, 368 U.S. 403, 411-12 (1961). Compare Judge Clark's dissenting remark in the Court of Appeals in the Blau case that the majority decision by following Rattner v. Lehman, supra note 52, "forces for [partnership] cases the very step which we felt Congress had avoided, namely, a

The holding of all three courts, including the Supreme Court, under the facts of the case may be stated as follows. If there is no evidence that the inside partner caused the firm to make either the purchase or the sale, that the inside partner had knowledge of the transaction, or that the purchase or sale was made as a result of inside information communicated by the insider to his firm, the firm which has engaged in short-swing trading cannot be held liable.[54] Only the director's share of the firm's profit was recoverable. Thus, the Supreme Court refused to extend 16(b) to include all persons realizing short-swing profits who could possibly possess inside information. The "might have been" approach was rejected in favor of a more liberal "what did happen" approach.

The Supreme Court enunciated an important dictum when it said that liability would exist if it were found that the partnership "actually functioned as a director through Thomas, who had been deputized by Lehman to perform a director's duties not for himself but for Lehman."[55] Liability in this area is made to depend upon a finding of fact, namely the existence of the requisite deputization of the inside partner by the firm to represent its interests. Here again the courts are sacrificing predictability in order to achieve equity through an *ad hoc* or case-by-case approach. The transition, however, is not yet complete. Presumably, if the director has been deputized, the courts will hold the firm without a showing of actual use of or intention to use inside information. In other words, it is only with regard to the initial problem of the status of a partner as director vis-à-vis his partnership (the deputization question) that the courts have adopted a subjective approach. It is somewhat difficult to see why, as a practical matter, the fact of deputization should be so crucial, unless it is fair to infer that the deputized director would be more likely in fact to disclose inside information to his partners than would the nondeputized director. It may well be that in practice there is little correlation between the fact of deputization and the likelihood of divulgence of inside information.

'subjective standard of proof, requiring a showing of an actual unfair use of inside information.'" Blau v. Lehman, 286 F.2d 786, 794 (2d Cir. 1960) (Clark, J., dissenting). But if it had been found as a fact that an undeputized Thomas had divulged confidential information to Lehman Brothers, then we would have had the "tippee" problem, and it is all but settled under current law that 16(b) does not reach the "tippee." See notes 32-34 supra and accompanying text.

[54] See Painter, supra note 27, for a recent discussion of the holdings and principles involved in Blau and a similar case, Rattner v. Lehman, supra note 52.

[55] Blau v. Lehman, supra note 53, at 410. It is relevant to note that there is a statutory route which will justify the Supreme Court's conclusion that the partnership may be considered a "director" under 16(b). Section 3(a)(9) of the Act, 48 Stat. 883 (1934), 15 U.S.C. § 78(c)(9) (1964), defines a "person" to include a partnership. Section 16(b) applies to any director. A "director" is defined in 3(a)(7), 48 Stat. 883 (1934), 15 U.S.C. § 78(c)(7) (1964), to include any person performing functions similar to those normally performed by a director. Therefore, if it is shown that an individual is deputized by a partnership to be "its" director, then the partnership itself can be considered to be a director.

To summarize, it seems clear that in this area the courts are unsatisfied with the harsh and arbitrary results which arise from a consistent application of 16(b). Here again is an area where the courts look to at least some of the facts. Why stop here? Would it not be better to ask whether Lehman Brothers (investment committee) did in fact possess inside information (assuming that Lehman Brothers was a "director" or that 16(b) reached a "tippee") rather than whether it has in fact deputized a partner? The former question goes to the heart of it all, whereas the latter approaches the problem only indirectly. It appears somewhat strained to reject the general "actual facts" approach on the ground that the facts are too difficult to prove and at the same time accept the approach involved in looking into the possibly "mystical" fact of deputization.[56]

E. *Computation of Profits under 16(b)*

Still another problem raised by the present nature of 16(b) is that it gives no insight into the proper method of computing the profit to be exacted from the defendant. In 1961 President Funston of the New York Stock Exchange testified during a congressional hearing that Congress ought to put some teeth into 16(b) "so that if some insiders do take short-term profits they have to pay some kind of a penalty instead of just paying the profits back."[57] Standing alone, President Funston's remark overlooks the interpretation which the courts have given to the words "profit realized" under 16(b).

The first 16(b) case to reach the courts, *Smolowe v. Delendo Corp.*,[58] settled the law as to the method of computing profit. *Smolowe* rejected the following possible methods of computation: (1) the first-in-first-out rule,[59] (2) averaging purchase and sale prices within a six-month period,[60]

[56] There are cases in other areas of 16(b) law where courts have, to some extent, looked at the actual facts. See, e.g., Colby v. Klune, 83 F. Supp. 159 (S.D.N.Y.), rev'd, 178 F.2d 872 (2d Cir. 1949) (whether production manager was an "officer"); Ellerin v. Massachusetts Mut. Life Ins. Co., 167 F. Supp. 71 (S.D.N.Y. 1958), aff'd, 270 F.2d 259 (2d Cir. 1959) (whether defendant was a 10% stockholder of a class of securities); Truncale v. Blumberg, 80 F. Supp. 387 (S.D.N.Y. 1948) (whether a gift was a "sale" for purposes of 16(b)).

[57] Securities Market Investigation, Hearings on H.J. Res. 438 Before a Subcommittee of the House Committee on Interstate and Foreign Commerce, 87th Cong., 1st Sess. 120 (1961).

[58] 136 F.2d 231 (2d Cir.), cert. denied, 320 U.S. 751 (1943). This aspect of the Smolowe case has been subsequently followed by courts on many occasions. See, e.g., Adler v. Klawans, 267 F.2d 840 (2d Cir. 1959); Walet v. Jefferson Lake Sulphur Co., 202 F.2d 433 (5th Cir.), cert. denied, 346 U.S. 820 (1953); Gratz v. Claughton, 187 F.2d 46 (2d Cir.), cert. denied, 341 U.S. 920 (1951); Arkansas La. Gas Co. v. Stephens Inv. Co., 141 F. Supp. 841 (W.D. Ark. 1956); cf. Stella v. Graham-Paige Motors Corp., 232 F.2d 299 (2d Cir.), cert. denied, 352 U.S. 831 (1956).

[59] The tax laws adopt a first-in-first-out presumption when the stock purchased and sold cannot be identified. See Treas. Reg. § 1.1012-1(c) (1958). Such a presumption in the 16(b) context would, however, allow evasion by encouraging the insider to keep a large inventory of securities. 2 Loss, Securities Regulation 1062 (2d ed. 1961).

[60] Averaging favors an insider who has previously bought at a high price. He would be

and (3) identifying stock certificates.[61] The test which was adopted requires the court to match the lowest (lower) purchases against the highest (higher) sales within any six-month period.[62] No deduction is allowed even though some of the purchases are at a price higher than some of the sales during the same six-month period. Let us illustrate the application of this test in three hypothetical situations:

Example #1 (one share throughout)

Date	Purchase Price	Date	Sale Price
1/1	$ 5	1/15	$ 10
2/1	$ 15	2/15	$ 20
3/1	$ 25	3/15	$ 30
4/1	$ 35	4/15	$ 40
	$ 80		$100

Example #2 (one share throughout)

Date	Purchase Price	Date	Sale Price
1/1	$ 10	1/15	$ 15
2/1	$ 15	2/15	$ 20
3/1	$ 20	3/15	$ 25
4/1	$ 25	4/15	$ 5
	$ 70		$ 65

Example #3 (one share throughout)

Date	Purchase Price	Date	Sale Price
1/1	$ 50	1/15	$ 45
2/1	$ 40	2/15	$ 35
3/1	$ 35	3/15	$ 30
4/1	$ 30	4/15	$ 25
	$155		$135

In example #1 the layman would say that the insider made $20 (100 — 80). Yet under 16(b) the insider would be required to turn over $50 [(40 — 5) plus (30 — 15)]. In example #2, whereas the layman would say that the insider lost $5 (70—65), a $20 [(25—10) plus (20—15)] recovery would be allowed. Example #3 is even more dramatic. Whereas the layman would say that the insider lost $20 (155 — 135), recovery would be for $15 (45 — 30). Thus, the company recovers "profits" in all three examples despite the fact that the insider actually

able to recoup his loss after a market fall by purchasing more shares on the basis of bullish information and then selling after the rise. Ibid.

[61] Identifying certificates is subject to the same objection as the first-in-first-out approach. Ibid. Also, both of these tests would create problems when applied to sales followed by purchases.

[62] Smolowe v. Delendo Corp., supra note 58, at 239.

made less profit in example #1, suffered an overall net loss in example #2, and suffered a net loss on each transaction in example #3.

The illustrated principle has reared its ugly head all too vividly in the "real world." For instance, in one case judgment was rendered against a ten per cent stockholder even though he had actually lost over $400,000.[63] Another case refused to allow the insider to submit evidence as to details of his transactions within the six-month period in order to show his actual profit.[64] Thus, the 16(b) rule of maximizing profits would seem to prevail regardless of any attempt by the insider to submit proof of the actual facts of the transaction.

The approach of the courts in the area of computation of profit is consistent with their approach in many other areas of 16(b) law; actual facts are disregarded in favor of hypothetical facts or arbitrary rules. However, the disinclination of the courts to examine actual facts in the area of computation of profit cannot be justified on the same ground as it was attempted to be justified in the other areas, *i.e.*, difficulties of proof. The courts must adduce proof as to all purchases and sales within the relevant time period in order to apply the formula illustrated in examples #1, 2, and 3. Ordinarily, then, it would be no more difficult to compute profit in the lay sense than in the "statutory" sense. Even if more proof were required to show the actual details of the transactions, the facts involved would not appear to be of a type that defy ready means of ascertainment or verification. This leaves us with the "broadly remedial" nature of the statute as the sole justification for current practice.

The general effect of the current interpretation is to give the statute a penal character, rather than construing it as an authorization for recovery of gains in such a way as to render insider trading unprofitable.

[63] Gratz v. Claughton, supra note 58. See also Adler v. Klawans, supra note 58, at 847-48. There is somewhat of a strain between the Gratz case and the later case of Epstein v. Shindler, 200 F. Supp. 836 (S.D.N.Y. 1961). The Epstein court held that a 16(b) action does not abate on defendant's death because it is primarily a civil action. The explicit rationale given was that liability imposed by 16(b) is measured by the "actual damage incurred." Although the Epstein court's holding would appear correct, its measuring instruments are badly in need of repair. The Gratz result cannot he easily explained in terms of the Epstein view that the object of the statute does not seem to be to punish the wrong-doer for his wrongful act, but rather to render him liable (only) to the extent of his conversion of a profit properly belonging to the corporation or its stockholders.

[64] Adler v. Klawans, 172 F. Supp. 502, 505 (S.D.N.Y. 1958), aff'd, 267 F.2d 840 (2d Cir. 1959). It was stated explicitly in the Gratz case that the statute does not allow the fiduciary to minimize his profits any more than to set off losses against them. Gratz v. Claughton, 187 F.2d 46, 51-52 (2d Cir.), cert. denied, 341 U.S. 920 (1951). The Gratz court purported to apply the principle of the ancient Chimney Sweeper's Jewel case, namely that when damages are at some unascertainable amount below an upper limit and when the uncertainty arises from the defendant's wrong, the upper limit will be taken as the proper amount. Amory v. Delamirie, 1 Strange 505, 93 Eng. Rep. 664 (K.B. 1722). The validity of the analogy is dubious in cases where the defendant would be able to prove the exact amount of his actual profit if the court gave him a chance, for then the damages would no longer be "unascertainable."

In other words, 16(b) has been construed to permit, in effect, a statutory action for punitive damages. On its face the statute lends no support to this construction. The words "profit realized" are not defined in 16(b), and the Commission has not undertaken to adopt a definitional rule. Generally, when words in a statute are not defined, they arguably should be given either a common law or a common sense (*e.g.*, dictionary) interpretation.[65] This desideratum has been quite obviously violated in the case of "profit realized" under 16(b). Lowest-in-highest-out is indeed a unique way to define the word "profit," and it is difficult to understand how an insider who has lost money on every transaction can be said to have "realized" profit. Thus, both the words "profit" and "realized" are harshly construed. All this is done under the guise of effectuating legislative purpose.

Yet one wonders, as a matter of sound legal process, whether it is wise for the courts to rewrite statutory language in second-guessing the legislative intent. This is not a case where it is necessary to twist the legislative words in order to make sense out of the statute. It would have been rational for Congress to have meant what it literally said; the recovery of "profit realized" in the common law or dictionary sense is not inconsistent with the statutory purpose behind 16(b). In fact, it might be argued that it is more consistent with the structure of 16(b) to avoid an interpretation which would lead to punitive damages, since 16(b) covers "innocent" as well as "guilty" violators. The "innocent" insider, who does not in fact use inside information, does not contribute in any way to the evil at which 16(b) was directed. It seems unfair to hit this man with the sledge hammer of punitive damages. All this is justified on the theory that his competitors might have some evil insiders.

Although 16(b) may have been intended to be "broadly remedial,"

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[65] It is difficult to square the general common law or dictionary definitions of "profit" as "advantage, gain, or benefit" with such decisions as Gratz. It is of interest to note that the Heli-Coil court cited both Webster's International Dictionary and Bouvier's Law Dictionary in ascertaining the meaning of "profit" in the context of a conversion; see notes 49-51 supra and accompanying text.

The Internal Revenue Service now (since 1961) in effect takes the word "profit" in 16(b) at face value rather than as an authorization of penal damages. Prior to 1961 the Commissioner and the Tax Court disallowed as a deduction the 16(b) payments which the insider was required to make to his company. I.T. 4069, 1952-1 Cum. Bull. 28; William F. Davis, Jr., 17 T.C. 549 (1951). The theory was that such payments were not an "ordinary and necessary business expense" because the sanction imposed by 16(b) was thought to be in the nature of a penalty. Cf. Tank Truck Rentals, Inc. v. Commissioner, 356 U.S. 30 (1958). In 1961 the Commissioner overruled I.T. 4069. Rev. Rul. 61-115, 1961-1 Cum. Bull. 46. The insider now is allowed to deduct his payments to the company. The Commissioner stated that the purpose of 16(b) was to place the insider in the same position that he would have occupied if he had never engaged in the stock dealings. Thus, the allowance of the deduction was seen to be consistent with the purpose of the statute. Although the Commissioner would seem to be correct, it is hard to reconcile his rationale with the position of the courts in their method of computing "profit."

that in itself should not constitute sufficient justification for altering statutory language. It should not be open for courts to implement statutory purposes by means of court-created sanctions when the legislature has provided its own sanctions, even if those of the court are more effective. It is not for the courts to impose a two-lash penalty when Congress has provided for one lash only. Perhaps President Funston was addressing himself to the proper body—Congress—in arguing for a penal 16(b). It would seem that this argument is better made to a Congress which has already expressed itself on the subject, rather than to the courts, the supposed interpreters of statutory language.[66] And yet the courts have uniformly accepted the argument with an enthusiasm born out of their ardent desire to castigate the evil insider.[67]

F. *The Problem of Enforcement of 16(b)*

The Commission has no enforcement functions under 16(b). Suits are brought by the issuer or, if the issuer fails to bring suit within sixty days after request, by a security holder in the name of the company. Thus in 16(b) suits the company is primarily intended as an instrument of statutory policy of which the general public is the ultimate beneficiary.[68] Therefore, the courts have been extremely liberal in allowing almost anybody having a "semblance of ownership" to bring suit in the company's name. Such a permissive attitude can be justified on the ground that the corporation often will be reluctant to bring suit against an insider.[69] Hence, it has been held that the plaintiff in a derivative suit need not be the beneficial owner of the security,[70] that he need not have been a security holder at the time of the transaction,[71] that he may sue even though his suit is a reprisal measure against the management,[72] and

[66] In this connection it is interesting, though probably legally irrelevant, to note that the lowest-in-highest-out test had been specifically included in the original bills leading to 16(b) and then was deleted without explanation. See S. 2693, H.R. 7852 § 15(b)(1), 73d Cong., 2d Sess. (1934).

[67] As a postscript, the writer would like to make it clear that he realizes that the arguments made in the last few paragraphs represent merely one view of the role of the courts in the legal process. Others would no doubt argue, and not without merit, that it is the business of the courts to interpret such statutory language as 16(b) with the primary aim in mind of doing all possible to punish insiders and thereby gain the maximum deterrence against future violations.

[68] Magida v. Continental Can Co., 231 F.2d 843 (2d Cir.), cert. denied, 351 U.S. 972 (1956); Silverman v. Re, 194 F. Supp. 540 (S.D.N.Y. 1961); Epstein v. Shindler, 26 F.R.D. 176 (S.D.N.Y. 1960); Benisch v. Cameron, 81 F. Supp. 882 (S.D.N.Y. 1948).

[69] Pellegrino v. Nesbit, 203 F.2d 463 (9th Cir. 1953). See also Dottenheim v. Emerson Electric Mfg. Co., 77 F. Supp. 306 (E.D.N.Y. 1948) (company delayed taking action in the hope that the law would be changed).

[70] Blau v. Lamb, 314 F.2d 618 (2d Cir.), cert. denied, 375 U.S. 813 (1963).

[71] Dottenheim v. Murchison, 227 F.2d 737 (5th Cir. 1955), cert. denied, 351 U.S. 919 (1956) (plaintiffs in 16(b) suits need not comply with Rule 23(b) of the Federal Rules of Civil Procedure); Blau v. Mission Corp., 212 F.2d 77 (2d Cir.), cert. denied, 347 U.S. 1016 (1954).

[72] Carr-Consolidated Biscuit Co. v. Moore, 125 F. Supp. 423 (M.D. Pa. 1954).

that it is irrelevant that his suit is being prosecuted solely for the benefit of his attorney.[73]

Since recovery in 16(b) cases runs to the corporation, one may wonder what motivates security holders to bring 16(b) suits. The incentive for the security holder to sue would indeed seem small. His pro rata interest in recovery usually will be too small to justify more than a fleeting interest. The satisfaction derived from a good deed well done may be a reliable incentive in Utopia but hardly qualifies as such in the business world of today. The sole stimulus is the possibility of recovering attorney's fees. The courts have recognized the public policy in favor of vigorous enforcement and have thus authorized substantial allowances. Fees have amounted to one-quarter, one-third or even one-half of the company's recovery.[74] The policy of the courts in awarding 16(b) allowances to plaintiffs' attorneys is far different from the rule applicable to allowances awarded in bankruptcy proceedings, where it is settled that the court should avoid "vicarious generosity" and should be economical in its distributions.[75] The reason for this difference, as before mentioned, is that courts in 16(b) cases have been eager to find any willing watchdog, and the plaintiff's attorney is thought to be the most practical candidate.

The problem created by the present mode of enforcement can be illustrated by the case of *Magida v. Continental Can Co.*[76] The defendant alleged champerty, *i.e.*, that the action was prosecuted for the benefit of plaintiff's attorney and not for the benefit of either the suing shareholder or the company. Defendant further argued that there was no bona fide relation between plaintiff and his attorney and that plaintiff would not have sued unless his attorney had undertaken the expenses of the suit. The plaintiff held ten shares, and recovery would have increased his equity by $1.10, but if he were unsuccessful the costs and expenses would have aggregated many hundreds of times that amount. The court held that these claims were irrelevant; it said in effect that Congress obviously preferred the public policy against violations of fiduciary responsibility to the violation of generally accepted ethics by attorneys.[77]

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[73] Magida v. Continental Can Co., supra note 68; see Lewis v. Rosenberg, CCH Fed. Sec. L. Rep. ¶ 90, 856 (S.D.N.Y. 1958) (by implication).

[74] See 2 Loss, Securities Regulation 1052 (2d ed. 1961) and cases cited therein.

[75] Levin v. Barker, 122 F.2d 969 (8th Cir.), cert. denied, 315 U.S. 813 (1941); Stark v. Woods Bros. Corp., 109 F.2d 969 (8th Cir. 1940); In re Standard Gas & Elec. Co., 106 F.2d 215 (3d Cir. 1939); see Rubin & Feldman, "Statutory Inhibitions Upon Unfair Use of Corporate Information by Insiders," 95 U. Pa. L. Rev. 468 (1947).

[76] 176 F. Supp. 781 (S.D.N.Y.), aff'd, 231 F.2d 843 (2d Cir.), cert. denied, 351 U.S. 972 (1956).

[77] 176 F. Supp. at 783.

In light of holdings such as this, it is no wonder that some attorneys assiduously read all insider reports filed under 16(a) in an endeavor to find sets of transactions within less than six months upon which some plaintiff is willing to sue.[78] To add insult to injury, the spoils are not even being divided evenly. One attorney has appeared as the plaintiff's attorney in so many 16(b) cases that a court went so far as to note the fact in an opinion.[79] Without in any way asserting or implying that any such activity has in fact occurred, it should be noted that an attorney, upon discovering a 16(b) violation, could well have his friend or brother-in-law buy one share of stock of the company involved and then institute a 16(b) suit. The courts sanction the past-mentioned practice. But is this really a good thing? Professor Loss apparently does not think so; he seems to deplore this practice.[80] An Ontario committee recently agreed; it rejected an adoption of 16(b) in Ontario on the ground that the result in the United States of inducing lawyers to institute actions for the purpose of obtaining legal fees is an "unseemly procedure."[81] And who can disagree?

In addition, recovery under 16(b) does not even inure to the injured party; the company is not hurt by the insider's transactions. It is the insider's vendor or vendee (or perhaps both) who is the injured party. However, it would seem impractical to compensate him under the present 16(b) statutory scheme. He has other remedies, such as those found at common law and under Rule 10b-5.

G. *Possible Value of Insider Trading*

It is not enough to say merely that an insider is a fiduciary of the company and its stockholders. Nor is it enough to say that abusive use of inside information by a fiduciary is a bad thing. These now obvious propositions do not necessarily lead to a justification of 16(b). Rather, the positive values attached to insider trading should be examined; it is only after doing so that we can fairly decide whether confiscation of all short-swing profits is justified.

The New York Stock Exchange has recently reported that stock-

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78 Halleran & Calderwood, "Effect of Federal Regulation on Distribution of and Trading in Securities," 28 Geo. Wash. L. Rev. 86, 114-17 (1959).

79 Fistel v. Christman, 133 F. Supp. 300, 304 n.4 (S.D.N.Y. 1955). (As an aside, it is worthy of mention that the attorney in this case attempted to carry a good thing too far in effectuating a dismissal conditioned solely upon payment of fees to himself with the corporation receiving nothing. The court held that fees would be awarded only where the company has benefited.) One attorney appeared in approximately twenty-one of the first forty-eight 16(b) cases; see Halleran & Calderwood, supra note 78, at 117 n.52.

80 2 Loss, Securities Regulation 1053-54 (2d ed. 1961).

81 Province of Ontario, Report of the Attorney General's Committee on Securities Legislation in Ontario § 2.28 (March 1965).

holders have indicated that they want officers and directors to have a meaningful investment in the companies they manage.[82] Directors and officers as shareholders are likely to better represent the viewpoint of the other shareholders whose interest they are charged with protecting. Stock ownership, whether through stock options, employee stock purchase plans, or otherwise, should provide additional incentive to insiders and thereby improve their performance. Judge Learned Hand has put the same idea in his own inimitable way:

> I conceive that the law allows a director to increase his stake in the company, because it adds to his incentive to make it succeed; the greater the prize, the greater the effort; it will dampen his zeal, if his holdings must be frozen at what he has when he is elected.[83]

Insider trading may also serve a useful function in retarding undue declines and rises in the market and otherwise broadening the market. The effect of 16(b), for example, is to force the insider who purchases stock in order to prevent a sudden or unreasonable decline to bear all risk of loss and to face confiscation of any profit. Thus, 16(b) arguably makes for non-liquid markets and sudden fluctuations, and it may deprive the market of a reliable source of support in bearish times.[84]

The proponents of 16(b) might answer these arguments as follows. The point that, generally speaking, insider ownership is valuable does not lead to the conclusion that we must permit short-swing profits in order to achieve most of the positive values of insider ownership. Even though it is impractical, if not inconsistent, to encourage ownership and at the same time forbid trading, 16(b) does not forbid trading since it is directed only at both purchases and sales within a relatively short period of time. Second, the argument that insider trading may serve a useful function in modifying market trends assumes that insiders will trade against the trend; even if this is true, it does not justify violations of fiduciary duties or self-dealing by trustees in trust assets.

In light of these two sets of arguments, each with much apparent merit, and in view of the many problems created by the present 16(b), it is desirable to ask whether we can improve upon 16(b) in an effort to have the best of both worlds—to cut down only the "Indians" while letting the "cowboys" live.

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[82] New York Stock Exchange, The Corporate Director and the Investing Public (1965).

[83] In re Calton Crescent, Inc., 173 F.2d 944, 952 (2d Cir.) (L. Hand, J., dissenting), aff'd sub nom. Manufacturers Trust Co. v. Becker, 338 U.S. 304 (1949).

[84] 2 Loss, Securities Regulation 1088 (2d ed. 1961); Investment Bankers Association, Report on the Conferences with the SEC and Its Staff on Proposals for Amending the Securities Act of 1933 and the Securities Exchange Act of 1934, 260-63 (1941).

II

IMPROVING THE UNENVIABLE POSITION OF THE 16(b) DEFENDANT

It can be seen from the above discussion that an "insider" who has made no use of inside information (the "innocent insider") is in an unenviable position. He may be held liable under 16(b), while a "guilty insider" may escape the net. He may be taken by surprise, not having realized that 16(b) would apply to his situation.[85] He will not even be allowed to bear the burden of proving his "innocence." If held liable, he may be forced to disgorge a "profit" when in fact he suffered a loss. And, finally, the suit which subjects him to liability may well be brought not to benefit the corporation or its shareholders, but to gain a fee for an attorney.

A. *The Question of Burden of Proof*

The solution proposed in this article would allow us to retain most of the positive values attached to insider trading, avoid the "unfair surprise" of the unsuspecting insider, and still remove the evils inherent in abusive use of inside information, by means of a change in the law relating to burden of proof in 16(b) cases. But first it is necessary to explore current law on the subject of burden of proof.

1. *The Law on Burden of Proof*

The law relating to burden of proof on the issue of liability *vel non* as depending upon the use of inside information is very simple. There is no such burden. Once the statutory conditions have been met, it is irrelevant that the insider either did not make unfair use of inside information or that he might not have intended, at the time he purchased the security, to sell within six months.[86] The approach of the law in this area is far different from that adopted in other areas of corporate law which allow an insider to deal with his company on certain terms—*e.g.*, in the leasing or sale of owned property to the corporation. The insider is permitted to explain and defend his actions in these other areas. It is interesting to note in this connection that it was argued both in the earliest 16(b) case and in one of the most recent 16(b) cases that the preamble of 16(b) requires some showing of unfair use of inside information.[87] In both cases, as well as in every other case in which the contention was

[85] However, it can be argued in rebuttal that ignorance of the law by insiders, who are in fact subject to 16(b), is an unusual ground upon which to make a claim of unfair surprise.

[86] See, e.g., Smolowe v. Delendo Corp., 136 F.2d 231 (2d Cir.), cert. denied, 320 U.S. 751 (1943) (the earliest 16(b) case); Heli-Coil Corp. v. Webster, 352 F.2d 156 (3d Cir. 1965).

[87] Smolowe v. Delendo Corp., supra note 86; Heli-Coil Corp. v. Webster, supra note 86, at 165.

made, the courts held that the preamble was not intended as a restriction on the scope of the act but was intended merely as an aid to constitutionality, as a guide to the SEC in its rule making, or as a premise upon which Congress was proceeding.

The rationale behind this position is not difficult to discern. In fact, one of the draftsmen of 16(b), Mr. Corcoran, testified before the Senate Committee on Banking and Currency that:

> 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 to prove that the director intended, at the time he bought, to get out on a short swing.[88]

Similar reasoning (*i.e.*, that a plaintiff could rarely, if ever, sustain the burden of proving that the defendant had obtained and used inside information) has led the courts uniformly to reject as a defense the contention, even though conceded by the plaintiff, that the defendant acted in good faith and without any unfair use of inside information.[89] In other words, it is entirely beside the point to inquire whether there was in fact any inside information or, if in fact there was such information, whether it was possessed, used, or abused by the insider.

2. *A Proposed Change in the Law Relating to Burden of Proof*

If, as would appear to be the case, one of the main reasons for not imposing a burden of proof upon the plaintiff is the difficulty which he would face in attempting to sustain the burden,[90] we are not forced to reach the 16(b) solution that all insiders must be held liable if they trade within a six-month period. The avenue remains open to impose a burden upon the defendant.

a. *The Proposal.* It is submitted that there should be a rebuttable presumption of "guilt" (the meaning of the terms "guilt" and "innocence" are explored in the next paragraph) which would apply when the insider's second transaction has followed his first transaction by less than one year. Conversely, the rebuttable presumption would be one of "innocence" when the insider's second transaction has followed his first transaction by between one and two years. Thus, on the one hand the plaintiff is aided by a presumption when the insider buys and sells within one year.

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[88] Hearings on S. 84, S. 56, S. 97 Before the Senate Committee on Banking and Currency, 73d Cong., 2d Sess. 6557 (1934).

[89] Babbitt, Inc. v. Lachner, 332 F.2d 255 (2d Cir. 1964); Magida v. Continental Can Co., 231 F.2d 843 (2d Cir.), cert. denied, 351 U.S. 972 (1956); Smolowe v. Delendo Corp., supra note 86; Marquette Cement Mfg. Co. v. Andreas, 239 F. Supp. 962 (S.D.N.Y. 1965); Arkansas La. Gas Co. v. W. R. Stephens Inv. Co., 141 F. Supp. 841 (W.D. Ark. 1956).

[90] See note 88 supra and accompanying text.

Yet the defendant will be allowed to prove his "innocence" in this situation if he can sustain the burden of proof. On the other hand, it is the defendant who is aided by a presumption when his second transaction is within the one- to two-year period after his first transaction. But in this situation the plaintiff will be allowed to prove defendant's "guilt" if he can sustain the burden of proof, the suit having been brought within two years after the profit was realized (the current statute of limitations period). In all cases the plaintiff would still retain the burden of proving the usually undisputed fact that the defendant did engage in a pair of transactions.

The words "guilt" and "innocence" in this context are not self-defining. They might be defined, for example, to refer to an intention on the part of the insider to engage in short-swing speculation (the relevant "date of intention" probably being the date of the first of the two transactions involved).[91] On the other hand, the crucial question of liability might be made to revolve not around the insider's intent, but rather the fact of his possession of inside information. It is this latter issue which would seem to be most important. In the first place, it might well turn out to be impractical, if not impossible, for the parties to adduce proof as to the intention of the insider and for the jury to make a determination on this issue. It would be easier to discover the more concrete fact of possession of inside information. What is even more important is that the "intention test" misses the point. Society should be after the evil doer, not the evil thinker.

Problems of definition also arise in determining what constitutes "inside information." The information must be of a kind which is not generally known to the public. Also, it must be "material" in the sense that it is something which a reasonable man would want to know in determining whether to buy from or sell to the insider. Definitions in this area are necessarily general, abstract, and elusive. However, this very vagueness in standards might well give to the fact-finder the flexibility necessary in order to do justice in the individual case.

The test here suggested is set up in terms of the "possession" of inside information, not its "utilization." The reason is that it should not be open to the possessor of inside information to claim that he made his investment decision on independent grounds. The jury could not easily separate the investment motives of the insider, and, moreover, the insider himself would probably never be able to remove such information from his investment decision.

[91] Apparently it was the difficulty of proving the intent of the insider to trade in the short-swing which led Mr. Corcoran to disfavor placing any burden of proof upon the plaintiff. See note 88 and accompanying text.

b. *Operation of the Proposal.* The "presumption" involved in the suggested change would be defined as follows: a procedural rule requiring the court, once it concludes that the basic fact is established (*e.g.*, a purchase and sale by an insider within one year), to assume the existence of the presumed fact (*e.g.*, that the insider possessed inside information) until the presumption is rebutted and thereby becomes inoperative.[92] The presumption should shift the burden of persuasion as well as the burden of producing evidence on the presumed fact. When the burden is thus shifted to the defendant, this procedural rule can be justified on the theory that an explanation of the short-swing trading at a profit would be more readily accessible to the defendant than to the plaintiff.[93]

Having determined (or at least argued) that the central issue of a 16(b) case should be the possession of inside information, it will be profitable to look more closely at what might be expected to occur at such a trial. The insider who had engaged in a pair of transactions within one year and thus had the burden of proof would presumably seek to make one of three general contentions: (1) that there was in fact no inside information to be had; (2) that, even if there were inside information, he did not have knowledge of it; or (3) that he disclosed all "inside" information that existed or that he possessed at the time of the transaction. It is necessary to note that under the proposed change the insider must clear himself on the sale side as well. The cure would be worse than the disease if we were to require that the insider misbehave on both ends of the transaction, rather than on just one end, before he could be held liable.

In support of any of the three general contentions above, an insider sued under 16(b) would like to prove any of the following facts as evidentiary of his "innocence," as that term has been hereinbefore defined.[94] Perhaps he was a participant in an established periodic investment program administered by his broker under which the timing of his purchases was outside of his control. Or perhaps he traded during a thirty-day period commencing one week after the annual report had been mailed to stockholders. Alternatively, the insider may have traded in the period following an informative release of quarterly results or the wide dissemi-

92 See Maguire, Weinstein, Chadbourn, & Mansfield, Evidence—Cases and Materials 698 (5th ed. 1965), stating that most text writers and many courts would define a presumption as it has been defined above.

93 Cf. Prosser, Torts 229-30 (3d ed. 1964). The application of "res ipsa loquitur" in negligence cases is often justified on the theory that evidence of the true explanation of the occurrence in issue is more accessible to the defendant than to the plaintiff.

94 See text accompanying note 91 supra. The ideas used in this and succeeding paragraphs are taken in part from the New York Stock Exchange's (noncrude) "rules of thumb" under which insiders are advised to buy stock in their company. New York Stock Exchange, supra note 82, at 12-13.

nation of information on the status of the company (*e.g.*, after a prospectus or proxy statement). He might like to show that the size of his purchase was relatively small, that he acquired the stock through a stock option or employee purchase plan (*qua* officer) approved by a majority of independent stockholders, that his purchase was not followed by a sharp and immediate rise in the market, and/or that he made little or no profit on the transaction.[95] Finally, he might like to prove that his purchase was not in fact followed by any development of major importance. (Incidentally, on the sale side of the ledger the insider often may wish to show the presence of personal considerations which necessitated or dictated his decision to sell at a particular time.) This enumeration, though not exhaustive, does show some of the possible factors to which the defendant might point in his attempt to exculpate himself. In rebuttal plaintiff, of course, would be able to cross-examine defendant's witnesses, as well as to introduce evidence of his own.

When defendant had traded outside of the one-year period but within the two-year period, the burden would be upon the plaintiff. He would like to show the converse of those factors which were previously mentioned in connection with the situation arising when the burden is on the defendant—*e.g.*, that the transaction took place just prior to an important press release, or that an important corporate development immediately followed the transaction. Again, the defendant would, of course, be allowed to cross-examine plaintiff's witnesses and introduce evidence of his own.

c. *Evaluation of the Proposal.* It is clear from the present law under 16(b) that no objection can be made to the proposal herein on the ground that the basic fact (short-swing insider trading) does not have any logical value as evidence of the presumed fact (the possession of inside information).[96] The main objection is the other way around, *i.e.*, that the basic fact has so much logical value as evidence of the presumed fact (this being derived from common experience) that the defendant should not even be allowed to come forward with proof. The theory here is that insiders so often possess and misuse inside information when they engage in short-term trading that it is not worth the judicial time and effort to salvage a few innocent insiders from the morass of evildoers.

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[95] It has already been shown that under the current construction of 16(b) the insider may be compelled to disgorge "profits" even though he in fact realized none (or even suffered a loss). See notes 62-64 supra and accompanying text.

[96] Cf. Tot v. United States, 319 U.S. 463 (1943). The Supreme Court invalidated a statute which made it unlawful for a convict or fugitive to receive firearms shipped through interstate commerce and which provided that possession created a presumption that such firearms were received in violation of the act. The rationale of the decision was that a statutory presumption cannot be sustained if there is no rational connection between the basic fact and the presumed fact as a matter of common experience.

However, this objection should be greatly alleviated by the suggested proposal. Under it, the courts would not be deluged by cases involving "guilty" 16(b) insiders, because only those who think they can sustain the burden of proof will defend an action rather than quietly paying over their profits, as is the current practice. Furthermore, the assumption that in a very high proportion of cases the insider has in fact used inside information seems questionable. In many 16(b) cases it is not claimed that the insider has in fact used inside information, or it is even conceded that he did not.[97] It should not be dismissed as totally irrelevant that self-imposed ethical strictures in the business community have come a long way since the passage of the Securities Exchange Act in 1934. It is arguable that the mores prevalent in the business community of today render the premise of 16(b) out-of-date or at least less realistic. This possibility is further strengthened by the fact that 16(b) applies only to the insiders of large companies, and these people are perhaps less likely to engage in unethical practices, especially since they must report their market transactions, than are those insiders of the fly-by-night companies who are not even covered by 16(b). It might be added that the birth and as yet undefinable growth of the equitable Rule 10b-5 may have rendered somewhat less necessary such unrefined approaches as that found in 16(b). In any event, even if the courts were forced to hear some cases in which the "guilty" insider tried to fool the jury or judge as to his innocence, it would seem that the resulting possibility of a heavier judicial workload, although a good argument for increasing the number of courts, is but a poor argument by which to justify a denial of justice to any member of society, be he an insider or otherwise.

It might be argued that the proposal is impractical because the insider could rarely prove the "negative fact" of an absence or lack of possession of inside information. Even accepting the premise of this argument, the answer is that the insider who engaged in a pair of transactions within a six-month period could not be worse off than he is under present law. The proposal at least gives him a chance in court. To the extent that these insiders find that they cannot meet the burden, they will not defend; their resulting position will be for all practical purposes the same as it is under current law. In addition, those "evil" insiders who complete their second transaction more than six months after the first transaction but within a one-year period will be brought under the statute. However, every time

[97] For a sampling of cases, see Jefferson Lake Sulphur Co. v. Walet, 104 F. Supp. 20 (E.D. La. 1952), aff'd, 202 F.2d 433 (5th Cir.), cert. denied, 346 U.S. 820 (1953); cases cited in note 89 supra; Brief for Appellants, Booth v. Varian Associates, 334 F.2d 1 (1st Cir. 1964). It is hard to evaluate the significance of this factor in light of the fact that, under present law, it is not part of plaintiff's case to allege or prove a use of information.

an insider is able to sustain the burden, society will have done justice in one more case.

The objection that plaintiffs will not be able to sustain their burden of proof seems to be vulnerable to the same criticism. Under the proposal, it must be remembered, the burden would be on plaintiffs only when the time interval between defendant's purchase and sale (or sale and purchase) was more than one year. Thus, to the extent that plaintiffs upon whom the burden is thrust find that they cannot meet the burden, they will not sue; their resulting position will be for all practical purposes the same as it now is under current law where they cannot sue on transactions spaced more than six months apart. But, to the extent that a plaintiff can sustain the burden, society will again have done justice in one more case.

The contention might be made that it ill behooves an insider to claim that he did not possess inside information when it was his duty to be aware of corporate developments. The theory here would be that the insider should not be allowed to defend on the ground that he violated his duty to the corporation. In answering this objection, it should be remembered that not all officers, directors, and especially large shareholders will have such a duty to be informed about recent developments. Most importantly, it would seem that the duty to keep abreast of corporate affairs and the duty to deal fairly in stock transactions are separate duties. The former can be considered primarily an internal corporate affair, whereas the latter is a matter in which the public has a strong interest. Accordingly, perhaps the remedy for a violation of the former should be by removal of the insider from office, rather than recovery under a statute which was aimed directly at a specific evil to which the unknowing insider does not in any way contribute.

The proposal has other merits. It avoids the current sharp and arbitrary distinction which catches the insider who completes his second transaction on the last day of the sixth month but allows his comrade who perhaps could not find a buyer until the next day to go off scot-free. Even when the one-year cut-off date is reached, the effect is only to place the burden of proof upon the plaintiff and not necessarily to defeat recovery. Along these same lines, the proposal avoids the present practice of playing into the hands of the tax-conscious insider, since the cut-off period occurs more than six months (the capital gains tax holding period) after the purchase.

The proposal also helps to alleviate the problem of the insider who merely buys or sells (but not both) within the current six-month period.[98]

[98] Another interesting way by which to attack the problem of the insider who merely engages in a purchase transaction on the basis of inside information of a bullish nature

Although it does not deal directly with a mere purchase or sale, it is designed to catch the insider when he completes his second transaction within two years of his first transaction. It is unlikely that many insiders who hold securities for a period longer than two years will be guilty of the abuses against which 16(b) is directed.

The suggested reform would hopefully avoid the general criticism of the present 16(b)—that it lets out some who should be caught and catches some who should be let out. Since the courts could look into the actual facts, a more equitable result should be reached in the individual case. Perhaps the reform would encourage insider stock ownership and trading, practices which in themselves are at least arguably beneficial. It is only the danger of possession of inside information which makes short-term insider trading undesirable; once the poison is removed, the trading itself has redeeming social utility. The proposal certainly would reduce any element of "unfair" surprise. The only surprised people would no longer have a very strong claim to protection, as they would by hypothesis be evil practitioners.

One real problem that might be raised by the proposal is in the field of enforcement. Although the present nature of 16(b) has led to the ethical problems outlined above, the "corporate gadfly" is still vital in the enforcement of the policy behind 16(b). If the proposal that we look to see whether the insider did possess inside information is accepted, then there will be many more factual issues in 16(b) cases than had been the case previously. In the light of the consequent increase in litigation costs, as well as the increased uncertainty of victory, we could not rely as confidently on the corporate gadfly to undertake litigation. Some further change in the law would have to be made, both to offset this expected decline in enforcement by "gadflys," and to treat the still present champerty problem.

d. *A Possible Solution of the Enforcement Problems.* Professor Loss[99] and Professor Cary[100] disagree concerning the proper way to handle the champerty problem which is currently presented by 16(b). Professor Loss believes that the solution to the problem lies in an active

would be to allow the company to compel the insider to sell his stock to the company at this purchase price. This would aid the company and indirectly its other stockholders because the company would have bought the stock at the lower purchase price and could immediately resell the stock at the higher market price. Despite its initial appeal, this idea would probably be impractical in that it would in effect put the corporation into the business of trading securities, thereby diverting it from its primary activities.

[99] The ideas attributed to Professor Loss in this section of the article are taken from 2 Loss, Securities Regulation 1051-55 (2d ed. 1961); Cary, "Recent Developments in Securities Regulation," 63 Colum. L. Rev. 856 (1963).

[100] The position attributed to Professor Cary in this section of the article is taken from Cary, supra note 99, and Cary, Book Review, 75 Harv. L. Rev. 857 (1962).

role for the Commission in the enforcement of 16(b) violations. Professor Cary, on the other hand, is satisfied with the *status quo*.

Professor Loss feels that decisions such as *Magida*,[101] where the judge said in substance that the statutory purpose can be effectuated only through unethical practices by attorneys, indicate that the basic policy of minimizing the government's role in private litigation—the only policy which, in his view, could explain the enforcement mechanism of 16(b)—has boomeranged. His solution is to substitute the Commission for any security holder as party plaintiff. More specifically, the Commission should be given the duty to bring suits whenever it considers that such course of action is proper, as well as to intervene in any action brought by the company, so as to assure proper prosecution. Recovery would still run to the company, but the court would award the Federal Treasury twenty per cent of the company's recovery, or perhaps some other amount which the court deemed proper in the particular case. This aspect of Professor Loss' proposed solution is based on the idea that allowances to the Treasury would more than pay for any additional Commission manpower. In addition, reimbursement to the Treasury whenever the company itself fails to sue after notice from the Commission,[102] or whenever the Commission intervenes and performs services over and above those rendered by company counsel, would encourage the company itself to sue as it should.

Professor Cary has taken issue with these views. He prefers the controls to be self-executing, without government intervention. In his view, 16(b) is an appropriate vehicle for the corporate gadfly who performs an essential public function despite his tarnished image. Payment of legal fees to attorneys of plaintiffs out of the corporate recovery has been found to be one of the few effective prophylactics in the prevention of corporate abuse. Professor Cary further notes that 16(b) suits generally present no factual problem, although often they raise very subtle legal issues. Since difficult and controverted issues of fact are absent, he thinks that we can count on private parties to bring suits. On a pragmatic level, the Commission does not have the manpower or financial resources to supervise and investigate so much litigation.

It seems to the author that Professor Loss has the better of the two sides. It is difficult to see why self-executing controls are necessarily

[101] Magida v. Continental Can Co., 176 F. Supp. 781 (S.D.N.Y.), aff'd, 231 F.2d 843 (2d Cir.), cert. denied, 351 U.S. 972 (1956); see text accompanying note 76 supra.

[102] The Ontario Committee also felt that under a statutory scheme such as 16(b) a governmental agency should have the right to bring the action if the company failed to do so within a reasonable time. It stated that the Ontario Securities Commission would be the logical agency to assume the responsibility. Province of Ontario, Report of the Attorney General's Committee on Securities Legislation in Ontario § 2.29 (March 1965).

preferable to government intervention. The courts apparently are very pleased with the assistance which the Commission has given to them in its currently restricted role as amicus curiae.[103] Admittedly, the fact that the Commission has provided useful and appreciated assistance to the courts in its capacity as amicus curiae does not lead us inexorably to the conclusion that the Commission should take over enforcement functions. However, it does indicate that on a practical level the Commission has been industrious and efficient in its working relationship with the courts.

The argument that payment of legal fees to attorneys has served as an effective prophylactic in the prevention of corporate abuse is counterbalanced by the attendant cost to society in terms of unethical legal practices. It does run very much against the grain to have a lawyer with a case looking for a client to bring it, rather than a client with a case looking for a lawyer to bring it. If we substitute the Commission for the corporate gadfly, we will still have an effective prophylactic, and the problem of champerty would disappear in the process.

The further argument that we can count on private enforcement in 16(b) cases since they generally present no factual problem is not beyond question. Part of this article has been intended to show that the courts have not in fact been able to avoid subjective or fact-oriented questions in many 16(b) cases.[104] At any rate, if the proposal is accepted that we look to see whether the insider did possess inside information, then there will indeed be many factual issues in 16(b) cases. Under this proposed state of affairs we could not rely as confidently on the corporate gadfly to undertake litigation involving some uncertainty and increased expenses. This would be an appropriate situation in which to call into play government resources.

Since the 16(b) plaintiff is enforcing solely a public interest, why not let the public to some extent enforce its own interest? It is worthy of note that the Commission is currently flexing its muscles, or at least testing them, in an analogous fashion under Rule 10b-5. In a recent case before a New York district court, the Commission in an unprecedented move requested and received rescission of tainted contracts and restitution from the defendants.[105]

[103] For example, the Court of Appeals for the Second Circuit, the author of virtually all 16(b) case law, has stated in an opinion that it welcomes the assistance of the Commission whenever the Commission sees fit to give its expert advice to the court. The Circuit Court went on to say that in some matters, such as allowances to counsel, it has deferred extensively to the Commission's conclusions. Greene v. Dietz, 247 F.2d 689, 695-96 (2d Cir. 1957) (Clark, J., concurring). The courts have expressed a similar sentiment on many subsequent occasions as well. See, e.g., Blau v. Lehman, 286 F.2d 786 (2d Cir. 1960) (Clark, J., dissenting), motion for rehearing denied, 286 F.2d at 797 (Clark, J., dissenting).

[104] See text accompanying notes 48-56 supra.

[105] SEC v. Texas Gulf Sulphur Co., CCH Fed. Sec. L. Rep. ¶ 91,805 (S.D.N.Y. 1966); see Note, 79 Harv. L. Rev. 656 (1966) (an analysis of the legal bases for such recovery by the SEC).

The following is a suggestion for the mechanical implementation of the past ideas. Upon discovery of a violation, the Commission would request the company to bring suit. If the company refused to do so within sixty days after request, then the Commission would itself bring the suit. The court would in its discretion award fees to the Treasury, the amount depending upon the fund recovered, the difficulty of the litigation, the time consumed, and the contribution made. If the company should fail to prosecute diligently any instituted action, then the Commission would be allowed to intervene, and the Treasury would be awarded fees for services which the Commission performed over and above those rendered by the company counsel. Hopefully, the result of all this would be that the Commission will have replaced the plaintiff's attorney as the statutory watchdog.

B. *Possible Change in the Method of Computation of Profits*

As we have seen, "profits" are computed under the present 16(b) in such a way that many defendants in effect pay punitive damages.[106] However, if the proposal to establish a burden of proof were accepted (with the probable result that insiders will be subject to 16(b) only if they have in fact abused their fiduciary duty), then, it is suggested, there would be no need to change the current law relating to computation of profit. By hypothesis punitive damages would be recovered only from those who had engaged in the very sort of evil practice which called for legislative reformation. Abusive use of inside information is not the kind of practice which lends itself to unwitting violations. Whereas it may be unjust to apply penal sanctions to mere technical violations of the law, there would not be such violations under the proposed revision of 16(b). In addition, the extra deterrent value involved in a penal recovery would be desirable; without such recovery, the exposed insider is merely returned to his financial *status quo ante*. In such a situation the only real deterrent to the insider, aside from the probability of being discovered, would be the intangible one resulting from adverse publicity. The efficacy of such "punishment" would vary with the individual case. Although it might be argued that 16(b) only applies to large companies and that the insiders of such companies have a public image to maintain, it still makes one feel more at ease to know that tangible and certain detriments will be suffered by the evil insider.

But the story is different when 16(b) is applied to "innocent" insiders, as occurs under current law. Insider trading, even in the short-swing, is not per se evil and is probably beneficial. Thus, deterrence is not of posi-

[106] See notes 62-64 supra and accompanying text.

tive value as applied to the "innocent" insider. This last factor should make us think twice before introducing penal or deterrent elements into an area of beneficial or, at the very least, neutral activity.

But if the burden of proof proposal is not adopted, with the result that the "guilty" and the "innocent" remain lumped in one category, then there should be some change in the method of computation of profit. In such a case it probably is better to err on the side of leniency in framing sanctions; it seems more desirable to slap the wrist of the "guilty" than to amputate the arm of the "innocent." In line with this article's theme of looking to the actual facts of 16(b) cases, the following is submitted as a fair and adequate test by which to compute actual profits.

Once a beneficiary shows short-term insider trading and prima facie proof of a maximum amount of profit (in the lay sense) made by the fiduciary, then the fiduciary has the burden of proving to what extent the profit was less than this maximum.[107] The justification for this rule lies in the fact that the fiduciary's behavior will normally be responsible for the difficulty of proving the amount of actual profit with certainty. If the fiduciary's proof leaves the amount uncertain, then judgment would be entered for the maximum figure. The insider, then, would at least have had an opportunity to limit his damages to a realistic figure.

III

Conclusion

Section 16(b) of the Securities Exchange Act of 1934 is in need of the substantial revision indicated in the accompanying appendix. Without disagreeing with the basic purpose of 16(b), it is submitted that that purpose can still be achieved, while at the same time the great number of hardship cases can be diminished, by removing the provision's present inflexibility. The defendant should be allowed to exculpate himself with proof that he did not possess inside information. Only those "guilty" insiders who in fact possessed inside information should be held liable for more than actual profits, as occurs under the present method of computing "profits." Finally, the Commission should be vested with the responsibility for enforcing 16(b), so that the present dependence upon corporate gadflies can be alleviated.

[107] Cf. Stella v. Graham-Paige Motors Corp., 232 F.2d 299 (2d Cir.), cert. denied, 352 U.S. 831 (1956).

APPENDIX

After inserting the major proposals suggested in this article, the "new" 16(b) would look something like the following. For purposes of comparison, the language of the present 16(b) which would be omitted in the new version is bracketed, and the suggested new language is italicized.

For the purpose of preventing the unfair use of information which [may have] *has* 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] *two years*, [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.] *Recovery shall be granted only upon a determination of the possession of inside information. There shall exist a rebuttable presumption of such possession where the beneficial owner, director, or officer has engaged in any purchase and sale, or any sale and purchase, within a one-year period. Where the second transaction has followed the first transaction by more than one year but by less than two years, there shall exist a rebuttable presumption that there has been no such possession of information. The term profit, as used in this subsection, shall be computed by matching the lowest (lower) purchases against the highest (higher) sales within any two-year period. No deduction shall be allowed for any losses.* 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] *the Commission* 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 *by the Commission* 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. *Fees shall be awarded to the Federal Treasury out of the company's recovery in the discretion of the court.* 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.