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Corporations--Securities Exchange Act of 1934, § 16(b)--"Sale" Defined

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The final conclusion which arises from this quagmire is that perhaps the Court acted unintentionally in omitting public discussion of its decisional process. Perhaps it saw no relevance in discussing the pre-decision logical step of resolving the conflict of *Thompson* and the incorporation doctrine. Perhaps it deemed inconsequential that its decision tacitly held that jury size is irrelevant to the jury's role. The truth of these assumptions would make one pause to contemplate the Court's capacity to act as a safe repository for constitutional rights in this era of problems so complex, so equitably balanced, so shrouded in uncertainty as to produce conflict among all aspects of American life.

Conversely, were the Court cognizant of these decisional facets while avoiding discussing either of them or the motivation of de-congesting the courts, then the opinion was less than candid. A full and open discussion, and a clear understanding, of the problem is essential to a constitutional decision. *Williams* evinces a lack of one, if not both, of these factors in allowing six-man juries based on the rationale stated in the Court's opinion.

*William L. Stevens*

**CORPORATIONS—Securities Exchange Act of 1934 § 16(b)—“Sale” Defined.—A corporate insider\(^1\) granted an option on stock which he...**

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\(^{1}\) Defendant was an insider by virtue of his ownership of over ten per cent of the outstanding stock of the Cudahy Company. Such insiders are subject to the provisions of section 16(b) of the Securities Exchange Act of 1934, set out below:

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 exempted security) within any period of less than six months, unless such security was acquired in good faith in connection with a debt previously contracted, shall inure to and be recoverable by the issuer, irrespective of any intention on the part of such beneficial owner, director, or officer in entering into such transaction of holding the security purchased or of not repurchasing the security sold for a period exceeding six months. Suit to recover such profit may be instituted at law or in equity in any court of competent jurisdiction by the issuer, or by the owner of any security of the issuer in the name and in behalf of the issuer if the issuer shall fail or refuse to bring such suit within sixty days after request or shall fail diligently to prosecute the same thereafter; but no such suit shall be brought more than two years after the date such profit was realized. This subsection shall not be con-

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and his wife had purchased less than six months before. The amount paid for the option could be applied against the option exercise price and equalled approximately fourteen per cent of such price. The optionor placed his stock in escrow and executed proxies, irrevocable until the option expired, in favor of the prospective purchaser. At the request of the optionee, the optionor and his business associate resigned from the board of directors of the corporation and were replaced by representatives of the optionee. Contending that the option was a sale within the meaning of section 16(b) of the Securities Exchange Act of 1934, and that such sale had occurred within six months of the purchase of the stock by the insider, plaintiff brought a shareholder derivative action to recover short-swing profits. Held: An insider's sale of an option within six months of his purchase of the underlying securities is a "sale" within the language of section 16(b) if the parties so treat it. *Bershad v. McDonough*, 428 F.2d 693 (7th Cir. 1970), cert. denied, 39 U.S.L.W. 3297 (U.S. Jan. 22, 1971) (No. 791).

Regarded by some as one of the most ambiguous provisions of all the New Deal securities legislation, section 16(b) represents part of Congress's attempt in 1934, five years after "Black Friday," to curb practices which had contributed to the collapse of the stock market and precipitated the Great Depression. The section is designed to

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deter advantageous use of corporate information by those “insiders” with greatest access to it—directors, officers, and beneficial owners of more than ten per cent of any class or equity security of the corporation. For any purchase and sale or sale and purchase of stock in the corporation by an insider within a six month period, recovery of all profit realized is permitted, either by the corporation or a stockholder suing in its behalf. Once those requirements are satisfied, liability flows automatically, irrespective of intent or actual misuse of inside information.6

Most of the section 16(b) litigation has been devoted to the threshold issue of when the “crude rule of thumb”7 of absolute liability will operate. While definitional problems have surrounded many of the statutory terms,8 none have evoked as much litigation as have the terms “purchase” and “sale.” Providing only that the term “purchase” include “any contract to buy, purchase, or otherwise acquire”9 and that the term “sale” includes “any contract to sell or otherwise dispose of”10 a security, the statutory definitions do not clearly cover or

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rectors and officers of corporations who used their positions of trust and the confidential information which came to them in such positions, to aid them in their market activities. Closely allied to this type of abuse was the unscrupulous employment of inside information by large stockholders who, while not directors and officers, exercised sufficient control over the destinies of their companies to enable them to acquire and profit by information not available to others. S. Rep. No. 1455, 73d Cong., 2d Sess. (1934).

5 The provisions of section 16(b) are remedial rather than penal. Yourd, Trading in Securities by Directors, Officers and Stockholders: Section 16 of the Securities Exchange Act, 88 Mus. L. Rev. 183, 151 (1939). However, the section takes on quasi-penal overtones because it imposes absolute liability without requiring motive, intent, knowledge or even misuse of inside information. Still the section has been upheld under due process attack on the rationale that potential liability flows from the voluntary assumption of insider status and its obligations and conditions. O'Neil, supra note 4, at 311.

6 As one of the draftsmen testified: “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 . . . to get out on a short swing.” Hearings Before the Senate Committee on Banking and Currency on S. Res. 84, 56, and 97, 73d Cong., 1st Sess., pt. 15, at 7266 (1934).

For a collection of other attempted defenses to have absolute liability of section 16(b), all of which have failed, see Comment, 11 Stan. L. Rev. 358, 359 n.12 (1959).

7 See note 6 supra.


exempt many common transactions. For example, stock warrants,\footnote{See Truncale v. Scully, 182 F.2d 1021 (2d Cir. 1950); Shaw v. Dreyfuss, 172 F.2d 140 (2d Cir. 1949), cert. denied, 337 U.S. 907 (1949).} options,\footnote{See Kornfeld v. Eaton, 327 F.2d 263 (2d Cir. 1964); Blau v. Ogsbury, 210 F.2d 426 (2d Cir. 1954).} exchanges\footnote{See Roberts v. Eaton, 212 F.2d 82 (2d Cir. 1954); Blau v. Mission Corp., 212 F.2d 77 (2d Cir. 1954).} and conversions\footnote{Conversion by an insider of preferred stock or bonds into common stock of the issuing corporation presents probably the most widely-litigated aspect of definitional problems of purchase and sale which are associated with section 16(b). For illustrative cases, see Heli-Coil Corp. v. Webster, 352 F.2d 159 (3d Cir. 1965); Ferraiolo v. Newman, 250 F.2d 342 (6th Cir. 1958), cert. denied, 359 U.S. 927 (1959); Park & Tilford, Inc. v. Schulte, 160 F.2d 984 (2d Cir. 1947), cert. denied, 332 U.S. 761 (1947).} have all produced confusion as to whether they constitute section 16(b) purchases or sales. Grappling with the complex, dissimilar fact situations and lack of help from the Supreme Court, several of the circuit courts of appeals have tried with little success to formulate a test which can tell us whether or not a given transaction is a purchase or sale within the meaning of section 16(b). To this amorphous body of case law, the Seventh Circuit now contributes Bershad, a case equitable in its result but of limited value to those seeking a reliable test of which stock options constitute section 16(b) sales.

The section 16(b) purchase and sale definitional problems were first dealt with in the Second Circuit case of Park & Tilford, Incorporated v. Schulte,\footnote{160 F.2d 984 (2d Cir. 1947), cert. denied, 332 U.S. 761 (1947).} where the court held that conversion of preferred shares to common stock constituted a "purchase" which could be matched with a later sale of the common to permit recovery of the shortswing profits. Although generally regarded as correct on its facts,\footnote{16 The defendants controlled the corporation and its decision to announce that the preferred stock was to be redeemed after ninety days. About a month after that announcement, defendants converted to common, the value of which soon began a spectacular rise due to a rumor of a future dividend in kind (liquor). Less than six months after conversion, defendants sold their common stock at handsome profits. The conversion from essentially unmarketable preferred to readily marketable common provided the defendants with great speculative abilities. See Comment, Convertible Securities and Section 16(b): The Persistent Problems of Purchase, Sale, and Debts Previously Contracted, 64 Mich. L. Rev. 474, 478 (1966); 36 U. Det. L. J. 343, 346 (1959).} the option propounded what later proved too broad a rule:

We think a conversion of preferred into common stock followed by a sale within six months is a 'purchase and sale' within the statutory language of § 16(b). Whatever doubt might otherwise exist as to whether a conversion is a 'purchase' is dispelled by definition of 'purchase' to include 'any contract to buy, purchase, or otherwise acquire.' . . . Defendants did not own the common stock in question before they exercised their option to convert;
they did afterward. Therefore they acquired the stock, within the meaning of the Act.17

Eleven years later, the Sixth Circuit in Ferraiolo v. Newman18 was forced to modify the broad language of Park & Tilford. On facts similar to Park & Tilford, the court held that the conversion of preferred to common was not a “purchase” because the preferred was the “economic equivalent” of the common, giving the defendants nothing which they had not already owned.19 Moreover, reasoned the court, the conversion was “in a very real sense involuntary,”20 because the preferred was about to be called at nine dollars per share less than the current market for the common, leaving defendant no realistic choice but to exercise his conversion privilege before the call.21 Therefore, “defendant’s conversion of Ashland preferred to Ashland common had none of the economic indicia of a purchase; it created no opportunity for profit which had not existed since 1948. The transaction was not one that could have lent itself to the practices which Section 16(b) was enacted to prevent.”22 In contrast to the “objective” view of Park & Tilford, eliminating any possibility of discretionary administration of section 16(b),23 Ferraiolo was labeled the “subjective” view which prevented calling the transaction a purchase or sale if it could not lend itself to the speculation encompassed by section 16(b).

Subsequent to the Ferraiolo case, other courts of appeals amplified the split in authority24 until 1966 when the Second Circuit rejected

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17 Park & Tilford Inc. v. Schulte, 160 F.2d at 987.
19 Id. at 345.
20 Id. at 346.
21 The court noted that no inside information was necessary to compel the conclusion that conversion was the proper course of action; the opportunity to do so was given to all preferred shareholders and more than 99% of them converted. 259 F.2d at 345. On the other hand, Park & Tilford preferred stock was essentially unmarketable, supra note 17, and shortswing speculation was possible only after converting to common. For a full analysis of this and other distinctions between Park & Tilford and Ferraiolo, see Comment, 107 U. PA. L. Rev. 719, 723 (1959).
22 Ferraiolo v. Newman, 259 F.2d at 346. This conclusion has been vigorously criticized in Comment, 107 U. PA. L. Rev. 719, 724-25 (1959), wherein the author contends that whatever the equality of speculative opportunities between preferred and common before the call of the preferred, defendant had to have common in order to keep his speculative advantage; that although conversion will probably proceed from legitimate motives, it is impossible to say that the conversion cannot possibly lend itself to insider speculation.
24 Most notable was Heli-Coil Corp. v. Webster, 352 F.2d 156 (3d Cir. 1965), which rejected outright the Ferraiolo v. Newman approach on very similar facts and foreclosed all inquiry into facts that might have indicated that it would have been impossible for defendant to exploit inside knowledge. The holding showed a clear preference for the Park & Tilford “objective” approach.

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its former "objective" approach ("automatic" seems the better word) in Blau v. Lamb. Faced with another conversion question, the court held that the crude rule of thumb could not be applied until it was determined whether the transaction in question "could not possibly serve as a vehicle for any of the abuses" that section 16(b) was designed to prevent. The Second Circuit's revised view has since been adopted by the Eighth Circuit, and it seems well settled now that a questionable transaction can be deemed a purchase or sale only if it lends itself to the abuses that section 16(b) proscribes. Against this background the Seventh Circuit was called upon in the present case to decide whether the defendant-insider completed a section 16(b) "sale" when he sold an option of his stock in the corporation.

To help it decide whether the "option" was a "sale" within the meaning of section 16(b), the court was confronted with circumstances that simply compelled the conclusion that the transaction contained possibilities for insider speculation. The $350,000 "binder" represented over fourteen per cent of the purchase price of the stock and was to be a retroactive down payment upon exercise of the option. Not only did defendant deliver the stock endorsed in blank to an escrow agent, he also executed irrevocable proxies in favor of the "optionee." The defendant and one of his associates resigned from the board of directors in favor of representatives of the "optionee." On these facts, the court held that the parties' treatment of the transaction rendered it a "sale" which occurred "well in advance of the exercise of the option; and the case stands for the proposition that under

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Sadly, the Third Circuit seems to have confused the "possibility of abuse" test (Ferraiolo) with the "crude rule of thumb" (Park & Tilford). The former determines only whether the transaction in question holds the possibility of unfair use of inside information; if the answer is "yes," then the latter is applied later in the proceedings for the sole purpose of obviating the need to prove the insider's intent. Comment, 64 MICH. L. REV. 474, 490 (1966). See also W. PAINTER, FEDERAL REGULATION OF INSIDER TRADING 48 (1968), referring to the Heli-Coil opinion as a "deliberate choice of the more conservative, if wooden, approach of the Park & Tilford line of authority."

26 Id. at 516.
27 The court was careful to make the distinction that the Third Circuit overlooked in Heli-Coil Corp. v. Webster, note 25 supra, which is that inquiry into whether there has been insider abuse of information would be improper—rather, the threshold issue of whether the transaction is a purchase or sale turns on whether it could lend itself to insider trading abuses. Id. at 516, 519.
29 428 F.2d at 698.
30 The option agreement was executed and the other pertinent events all had occurred by July 25, 1967. The option was formally exercised by the optionee on
these circumstances a sale has been made within the meaning of the statute because the optionor had parted with so many of the attributes of ownership that the transaction was tantamount to a sale. The case is silent, however, as to which (if any) of the additional circumstances must surround the option agreement to transform it into a section 16(b) "sale." What result if defendant and his associate director had not resigned? Would there still be a sale absent the escrow and proxy arrangements? And what if the option binder price had not been applied as retroactive down payment on the purchase price? Finally, is the option agreement alone a section 16(b) sale?

Being a species of unilateral contract, an option is logically a "contract to buy" or a "contract to sell" within the statutory purchase and sale definitions. But the logical analysis makes no judgments and inquiry is necessary as to whether the option could lend itself to insider trading abuses. An insider who buys an option has a right, but no obligation, to buy, while one who sells an option has an obligation to sell but no right to force the optionee to buy. Has a purchase or sale occurred when rights or obligations, but not both, have been determined? At least one court has said that both rights and obligations must always be fixed in order for there to be a purchase or sale because, until then, change occurs only at the pleasure of the optionee. This begs the question when an insider is the optionee because it is precisely his pleasure at whom section 16(b) is directed. The statement also appears to be incorrect when the insider is an optionor, as was Mr. McDonough. The court in Bershad observed:

The insider's sale of options in his stock is well adapted to speculation and abuse of inside information whether or not the option is subsequently exercised. The sale of the right to purchase the underlying security is itself a means of realizing a profit from that security.

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Sept. 27, 1967. In order for section 16(b) liability to attach, the court had only to find that the sale was completed prior to Sept. 15, 1967, since defendant had purchased the stock in question on March 15, 1967. 428 F.2d at 698.

31 I. CORBIN, CORBIN ON CONTRACTS § 260 (1952).
32 See note 9 and 10 supra, and accompanying text.
33 Silverman v. Landa, 306 F.2d 422 (2d Cir. 1962).
34 For a thorough analysis of this problem and a hypothetical fact situation demonstrating the possibilities of abuse when the insider is the optionee, see Michaely & Lee, *Put and Call Options: Criteria For Applicability of Section 16(b) of The Securities Exchange Act of 1934*, 40 NOTRE DAME LAW. 239, 242-45 (1965).

Options . . . have lent themselves quite readily to the abuses uncovered in the Congressional investigation antedating the Act, and in order to give
It is submitted that the above observation by the Seventh Circuit Court of Appeals should have been dispositive of the instant case. This is the "possibility of abuse" threshold inquiry which now is apparently agreed upon, and once the court finds such a possibility of abuse, liability should be automatic. By resting its decision instead on the several aggravating circumstances surrounding the option, this court has transformed what would have been the heart of a milestone decision into dictum. True, the tenor of the opinion suggests that section 16(b) liability will attach to a simple option granted by an insider, but such a holding has been reserved for future litigants. Until this or some other court is willing to so hold, elaborate and ingenious "option" agreements can be expected to continue in the service of those who would avoid the "crude rule of thumb" of section 16(b).

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maximum support to the statute courts have attempted to include these transactions by characterizing them as purchases or sales. 334 F.2d at 3.

See note 28 supra, and accompanying text.