

COUNSEL FEES FOR DISCOVERY AND RECOVERY OF SHORT-SWING PROFITS

Under present law counsel fees are recoverable for services instrumental in the enforcement of section 16(b) of the Securities Exchange Act of 1934. While vital to the effective enforcement of section 16(b), such fees tend to encourage overzealous investigation by shareholders' attorneys which often approaches unethical conduct. Recent decisions have attempted both to encourage enforcement and discourage unfavorable conduct. This note analyzes current case law in an attempt to determine whether it has so succeeded, and suggests an alternative which may provide effective enforcement of section 16(b) and yet avoid the ethical dilemma.

Section 16(b) of the Securities Exchange Act of 1934 seeks to check the unfair use of inside information by corporate officers, directors, and large shareholders to produce short-swing profits, by authorizing the issuer or any owner of any security of the issuer to bring suit to recover such profits.¹ It is uniformly agreed that the opportunity to recover counsel fees in such a suit is a major stimulus to the enforcement of 16(b).² However, the present statutory scheme tends to promote unethical conduct approaching

¹ 15 U.S.C. §§ 78p(a) & (b) (1964): "Every person who is directly or indirectly the beneficial owner of more than ten percent of any class of any equity security . . . registered . . ." on a national securities exchange, or who is a director or an officer of the issuer of such a security who makes any profit "from any purchase and sale, or any sale and purchase, of any equity security of such issuer . . . within any period of less than six months, unless such security was acquired in good faith in connection with a debt previously contracted," shall be subject to the right of the issuer to recover such profit irrespective of the motive or intent of the beneficial owner, director or officer. "Suit to recover such profit may be instituted . . . by the issuer or by the owner of any security of the issuer . . . 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." See generally 2 L. LOSS, *SECURITIES REGULATION* 1037, 1051-55 (2d ed. 1961) [hereinafter cited as LOSS]; Cook & Feldman, *Insider Trading Under the Securities and Exchange Act*, 66 HARV. L. REV. 385, 421-22 (1953); Comment, *Insider Trading: The Issuer's Disposition of an Alleged 16(b) Violation*, 1968 DUKE L.J. 94, 102-08; 64 COLUM. L. REV. 1343 (1964).

² See, e.g., *Smolowe v. Delendo Corp.*, 136 F.2d 231 (2d Cir. 1943); *Magida v. Continental Can Co.*, 176 F. Supp. 781 (S.D.N.Y. 1956); 2 LOSS at 1042, 1051-55; 64 COLUM. L. REV. 1343, 1344 (1964); 69 HARV. L. REV. 1146 (1956). Under section 16(a) all beneficial owners are required to file within ten days after the close of any calendar month during which there has been a change in their beneficial ownership of the issuer's stock. See

champerty³ since it encourages members of the disinterested public to become involved in corporate litigation for profit. In addition, the decisions rendered to curb such practices have endangered the future effectiveness of 16(b) enforcement by creating great delay in the recovery of short-swing profits while failing to specify the standard for recovery of counsel fees.⁴ It is submitted that these undesirable consequences could be substantially avoided through a simple statutory revision.

At common law counsel fees are recoverable in several instances after a derivative suit has been brought by a shareholder, on behalf of the other shareholders and the corporation, to redress a wrong done to the corporation.⁵ As a rule, if a plaintiff-shareholder's suit is successful in protecting or augmenting corporate property, counsel fees are recoverable from that property since a pecuniary benefit has been rendered to the corporation.⁶ Furthermore, even if a successful judgment is not obtained, recovery of fees will generally follow a showing that through the efforts of counsel some benefit inured to the shareholder class. If, after the plaintiff-shareholder files suit, a settlement is procured either by the corporation or plaintiff, often plaintiff is entitled to reimbursement for attorney's fees.⁷ Similarly, if remedial action taken by the corporation or

15 U.S.C. § 78p(a) (1964). Such records are available to the public and serve as the major method by which attorneys discover 16(b) violations.

³ See *Magida v. Continental Can Co.*, 176 F. Supp. 781, 782-83 (S.D.N.Y. 1956); 2 Loss at 1052-53; 64 COLUM. L. REV. 1343, 1345 (1964); 1968 DUKE L.J., *supra* note 1, at 104; 69 HARV. L. REV. 1146 (1956). Champerty consists of an agreement whereby a person without an interest in another's suit undertakes to carry it on at his own expense in consideration of receiving in the event of success a part of the proceeds of the litigation. See, e.g., *Wilhoit's Adm'x. v. Richardson*, 193 Ky. 559, 236 S.W. 1025 (1921).

⁴ See, e.g., *Blau v. Rayette-Faberge, Inc.*, 389 F.2d 469, 473 (2d Cir. 1968); *Gilson v. Chock Full O' Nuts Corp.*, 331 F.2d 107 (2d Cir. 1964). See notes 25-27 *supra* and accompanying text.

⁵ See, e.g., *Klopstock v. Superior Ct.*, 17 Cal. 2d 13, 108 P.2d 906 (1941).

⁶ See, e.g., *Hutchison Box Board & Paper Co. v. Van Horn*, 299 F. 424 (8th Cir. 1924); *Vigran v. Hamilton*, 321 Ill. App. 541, 53 N.E.2d 250 (1944); *Martin Foundation, Inc. v. Phillips-Jones Corp.*, 283 App. Div. 729, 127 N.Y.S.2d 649, *aff'd*, 306 N.Y. 972, 120 N.E.2d 230 (1954). In *Eriksson v. Boyum*, 150 Minn. 192, 184 N.W. 961 (1921) the court stated that when an action brought on behalf of the corporation is successful the court may make the attorney's fees a charge against the corporation, but if the action results in failure, he who volunteers his services is alone responsible for the cost and expense incurred. See *Angoff v. Goldfine*, 270 F.2d 185, 188-89 (1st Cir. 1959), for factors to be weighed in the federal courts to determine the figure for counsel fees.

⁷ *Pergamet v. Kaiser-Frazer Corp.*, 224 F.2d 80 (6th Cir. 1955). See, e.g., *Blau v. Allen*, 171 F. Supp. 669 (S.D.N.Y. 1959) (40% of the recovery as counsel fees was exorbitant in

individual defendants is attributable to the initiation of suit, counsel fees may also be awarded.⁸ There are at least two situations, however, where the attorney is considered a "mere volunteer" at common law and has no right to reimbursement: where he is merely doing investigatory work pursuant to an agreement with an attorney of record and is not representing a potential plaintiff,⁹ and where he merely discovers a claim but no suit is ever filed by anyone other than the corporation.¹⁰

Although a 16(b) shareholder suit is not a common law derivative action because its purpose is to recover a penalty payable to the corporation rather than a fund belonging to it, courts have held that in certain circumstances following a 16(b) violation a derivative right to recover counsel fees is created for the benefit of parties who prosecute or help to prosecute the violation.¹¹ Such counsel fee recoveries are, according to judicial authority, in the public interest because they encourage policing of short-swing insider's profits—the primary purpose of section 16 of the Exchange Act.¹² Furthermore, just as in a shareholder's derivative

absence of a detailed showing of services, but reasonable fees were to be permitted); *Goodwin v. Castleton*, 19 Wash. 2d 748, 144 P.2d 725 (1944) (although application for fees was premature, fees would be permitted upon a showing that the corporation had benefited). See also Comment, *The Counsel Fee in Stockholder's Derivative Suits*, 39 COLUM. L. REV. 784, 804-08 (1939).

⁸ See, e.g., *Dottenheim v. Emerson Elec. Mfg. Co.*, 77 F. Supp. 306 (E.D.N.Y. 1948); *Kaufman v. Shoenberg*, 33 Del. Ch. 282, 92 A.2d 295 (1952). See also Comment, *The Counsel Fee in Stockholder's Derivative Suits*, 39 COLUM. L. REV. 784, 798-804 (1939).

⁹ *Ripley v. Int'l Ry. of Cent. Am.*, 16 App. Div. 2d 260, 227 N.Y.S.2d 64, *aff'd*, 12 N.Y.2d 814, 236 N.Y.S.2d 64 (1962); *Waterman Corp. v. Johnston*, 122 N.Y.S.2d 695, 701 (Sup. Ct. 1953).

¹⁰ But see *Kaufman v. Shoenberg*, 33 Del. Ch. 282, 92 A.2d 295 (1952). The court, citing 60 HARV. L. REV. 835 (1947), argued that a stockholder should be entitled to reasonable investigation fees if a demand for action made to the corporation by the shareholder is first refused by the company. However, the Harvard note based its reasoning on a section 16(b) case, *Dottenheim v. Emerson Elec. Mfg. Co.*, 77 F. Supp. 306 (E.D.N.Y. 1948). Thus, *Kaufman* could not be utilized to extend its holding to section 16(b) suits in general. See generally Comment, *The Counsel Fee in Stockholder's Derivative Suits*, 39 COLUM. L. REV. 784 (1939).

¹¹ See, e.g., *Smolowe v. Delendo Corp.*, 136 F.2d 231, 241 (2d Cir. 1943). See 2 LOSS at 1052; 60 HARV. L. REV. 835 (1947). It is interesting to note that courts have reached this conclusion in spite of the fact that whereas sections 9(e) and 18(a) of the act expressly provide for the recovery of counsel fees, 16(b) does not; and the implication would seem to be that Congress did not intend counsel fees to be recoverable under 16(b). 15 U.S.C. §§ 78i(e) & 78r(a) (1964).

¹² A federal district court has indicated that 16(b) suits must be encouraged to protect public welfare. *Magida v. Continental Can Co.*, 176 F. Supp. 78 (S.D.N.Y. 1956). Further,

suit, a 16(b) plaintiff, or potential plaintiff, moves to benefit the entire class of shareholders and should thus have a similar right to recover the expenses incurred. The fact that 16(b) judgments are penalties rather than recoveries of assets formerly belonging to the corporation¹³ does not weaken the argument for recovery of counsel fees, because the fees are deducted in either case from assets rightfully belonging to the corporation.

There are times, however, when the analogy between common law derivative and 16(b) suits becomes strained. In particular, the strain arises from the statutory requirement that upon discovery of a 16(b) violation a potential plaintiff must give the corporation notice and then wait for sixty days before initiating his individual action. He may thus incur expense prior to the time when he can file suit, and the corporation may bring suit or settle during this sixty-day period,¹⁴ or settle the claim even after he files. Where the corporation settles after an individual 16(b) plaintiff files, there is little problem: counsel fees are recoverable just as in a common law derivative action, but with the restriction that the reasonableness of the fee may be reviewed on appeal.¹⁵ Where the corporation settles or files suit during the sixty-day period, however, the analogy to recovery of fees for attempted prosecution of a derivative action breaks down. Nevertheless, courts have declined to adopt a *general* rule refusing recovery,¹⁶ reasoning that the interest of the attorney

the requirement that a 16(b) plaintiff must have been a shareholder at the time of the violation has been abrogated to encourage outside enforcement. *Blau v. Mission Corp.*, 212 F.2d 77, 79 (2d Cir.), *cert. denied*, 347 U.S. 1016 (1954), and courts have refused to allow defendants to attack the motives of plaintiff-shareholders' attorneys. *See, e.g., Pellegrino v. Nesbit*, 203 F.2d 463, 466 (9th Cir. 1953); *Craftsman Fin. & Mortgage Co. v. Brown*, 64 F. Supp. 168, 178 (S.D.N.Y. 1945); *see also* 2 Loss at 1052-53. One court even declined to entertain a claim of champerty where an attorney had initiated the agreement to bring an action and had financed the suit. *Magida v. Continental Can Co.*, *supra*; 64 COLUM. L. REV. 1343 (1964).

¹³ *See Blau v. Rayette-Faberge, Inc.*, 389 F.2d 469, 474 (2d Cir. 1968).

¹⁴ *See* note 1 *supra*.

¹⁵ The courts must grant leave for and approve any private settlement subsequent to the filing of suit. *Fistel v. Christman*, 133 F. Supp. 300 (S.D.N.Y. 1955). In *Fistel* the court refused to permit settlement on the ground that no benefit would inure to the corporation from the proposed settlement, as plaintiff had sought to recover fees from defendants in return for dropping prosecution without making any provision for repayment of the profits to the corporation. Such settlement, the court said, would be contrary to the purpose of the statute. *See Blau v. Allen*, 171 F. Supp. 669 (S.D.N.Y. 1959).

¹⁶ In *Dottenheim v. Emerson Elec. Mfg. Co.*, 77 F. Supp. 306 (E.D.N.Y. 1948), *hearing on motions to dismiss*, 7 F.R.D. 195 (E.D.N.Y. 1947), plaintiff's attorney was hired on a

in seeking clients and fees may often be the sole incentive for the enforcement of 16(b);¹⁷ to deny fee recovery where no suit is ever filed by one other than the corporation would be penalizing the effective 16(b) private investigators for the efficiency of those corporations which choose to settle or pursue 16(b) claims within the statutory sixty-day period.¹⁸ Under present case law as developed in the United States Court of Appeals for the Second Circuit, however, the recovery of counsel fees where the corporation has settled or filed suit during the sixty-day period has been limited by the "substantial period" test.¹⁹ Under that test, when a shareholder's attorney seeks to recover for a *complaint* drafted during the statutory period, he will be compensated for his efforts *only* where he has given the corporation notice near the end of the two-year 16(b) statute of limitations²⁰ and received evasive replies as to whether the corporation would seriously pursue recovery of the short-swing profits.²¹ Only then is the *drafting of a*

contingent basis to investigate possible 16(b) violations. After discovery, the attorney sent a letter to the corporation which resulted in remedial action by defendant. The court concluded that there was no contractual relationship between plaintiff's attorney and the corporation on which to base recovery of counsel fees, and also that 16(b) suits are not technically derivative suits. However, while the court acknowledged that only a letter was sent, and that the only benefit rendered was use of the fund for some ten months, a recovery of \$1000 was permitted to plaintiff as reasonable counsel fees.

¹⁷ See note 2 *supra* and accompanying text.

¹⁸ *Blau v. Rayette-Faberge, Inc.*, 389 F.2d 469, 473 (2d Cir. 1968). See also *Gilson v. Chock Full O' Nuts Corp.*, 331 F.2d 107 (2d Cir. 1964); *Dottenheim v. Emerson Elec. Mfg. Co.*, 77 F. Supp. 306 (E.D.N.Y. 1948), *hearing on motions to dismiss*, 7 F.R.D. 195 (E.D.N.Y. 1947).

¹⁹ See *Blau v. Rayette-Faberge, Inc.*, 389 F.2d 469 (2d Cir. 1968); *Gilson v. Chock Full O' Nuts Corp.*, 331 F.2d 107 (2d Cir. 1964).

²⁰ See note 1 *supra*.

²¹ *Gilson v. Chock Full O' Nuts Corp.*, 331 F.2d 107 (2d Cir. 1964). In *Gilson* the stockholder's attorney uncovered a 16(b) violation, but because of the impending expiration of the two year statute of limitations and negative and evasive response of the corporation to his statutory request for action, he also prepared a complaint prior to the running of the sixty day period. On the issue of counsel fees the court concluded that equity generally treats a shareholder who merely discovers a claim and brings it to the attention of the company as an informer or volunteer regardless of the time, effort or money expended. In addition, the court alluded to policy considerations against requiring a corporation to ". . . pay a stockholder for volunteering to do what the corporation ought to do and might well have done . . ." *Id.* at 109. While the court did not spell out the policy factors, it did state that they would be particularly strong in a case where the shareholder's request was made soon after the information became available through the 16(a) reports. However, the court held the preparation of the complaint by counsel reasonable and compensable in light of the impending expiration of the statute of limitations.

complaint during the sixty-day period deemed "appropriately rendered." Similarly, where a shareholder's attorney seeks to recover for *investigation* and *discovery* of a 16(b) claim during the period and where the corporation thereafter filed suit or settled, ". . . [fee] recovery will be allowed only if the corporation has done nothing for a substantial period of time after the suspect transactions and its inaction is likely to continue."²²

The "substantial period" test reflects both an attempt to encourage effective outside enforcement of 16(b) and a desire to allow corporations time to remedy violations from within. Certainly, the Second Circuit recognized that without some allowance for recovery of discovery and drafting expenses during the sixty-day period, corporations could ignore 16(b) infractions unless faced with a shareholder's request, and that by prosecuting all such requests, insiders could work toward the day when no attorney would find it profitable to investigate 16(b) violations. On the other hand, the court realized the need for slower and better-reasoned research by both corporations' and shareholders' attorneys, as well as the need to prevent duplication of work product²³—a need which conceivably would be served by encouraging corporations independently to recover 16(b) profits long before private expenses would be incurred.²⁴ Analysis, however, reveals that the "substantial period" test only partially solves the problem of proper outside enforcement of 16(b). As a practical matter, it is generally recognized that corporations rarely police

²² *Blau v. Rayette-Faberge, Inc.*, 389 F.2d 469, 473 (2d Cir. 1968). In *Blau* plaintiff brought suit to recover expenses incurred by his attorney during investigation of insider transactions. After discovery of a violation of 16(b), counsel advised the company of its cause of action, and the profits were recovered without the need for court action. The Court of Appeals for the Second Circuit reiterated its statement from *Gilson* that it had not yet been necessary to decide the narrow issue of counsel fees for mere discovery of a claim. In an attempt to avoid the evils of champerty and duplication of services on the one hand and total denial of fees in the absence of suit on the other, the court struck a middle ground. Applying the "substantial period" test to the facts, the court decided that as the corporation had done nothing prior to receiving the statutory notice, and as it had already allowed the statute of limitations to run on one other series of transactions by defendant, it was likely that the company's inaction would continue. Thus, recovery for discovery was permitted, but returning to *Gilson* for the test to be applied to the complaint drawn by plaintiff's counsel, the court held that as there was no danger of the statute of limitations running prior to the end of the sixty day period, the drafting of the complaint was not "appropriately rendered."

²³ *Gilson v. Chock Full O' Nuts Corp.*, 331 F.2d 107 (2d Cir. 1964).

²⁴ *Blau v. Rayette-Faberge, Inc.*, 389 F.2d 469 (2d Cir. 1968).

16(b) violations;²⁵ the corporations are often no more than alter egos of those against whom the section is aimed. It is still up to someone other than the corporation to insist upon enforcement. Thus, under the "substantial period" test one probably can either investigate as soon as the reports are released and wait more than a year to make the statutory request with little fear of the corporation taking action, or completely abandon the investigation of current transactions and consult only reports of at least one year's vintage. In effect, one who is interested in profiting from investigating 16(a) reports can do so as easily now as before the promulgation of the Second Circuit test. Moreover, it is unlikely that an investigator would expend any more effort now than before since certainty of expense recovery has been undercut by the test's vague outline. Corporations may also suffer. Actual ability to recover short-swing profits may have been decreased by introduction of the "substantial period" test since procurement of evidence and testimony and the chances of a solvent defendant are better at the time of the violation than two years later; furthermore, even if the corporation does recover as the result of an outsider's efforts, it will probably be without use of the profits for an extra two years.

Additional criticism may be lodged against the "substantial period" test. If a 16(b) statutory request is sent the day the 16(a) reports are available, and the corporation does nothing for sixty days, the moving shareholder will receive full compensation for counsel fees after a successful trial *even if he files suit sixty-one days after the reports are available*. On the other hand, if the corporation does take action, then the courts penalize the attorney for being overzealous and deny him recovery for his services to that time. Thus, unless the attorney delays for nearly two years the corporation by its reaction to the statutory request could arbitrarily control the recovery of counsel fees. Furthermore, the "substantial period" test is hardly reflective of legislative intent. The statute permits stockholder requests to be sent at *any* time during the two-year statute of limitations period, indicating that Congress did not deem it advantageous to 16(b) enforcement to allow the corporation any time during which to voluntarily act without shareholder prodding. In practice, however, this is exactly what the current case law

²⁵ See note 2 *supra* and accompanying text.

provides. It appears, therefore, that the courts should either condone the risk of champerty and duplication and admit that delay will not significantly increase the level of inside enforcement of 16(b) on the theory that the public interest in enforcement of that section overrides the risks of these evils, or provide a concrete alternative to the Second Circuit test.

A viable alternative would be statutory provision for two sixty-day periods rather than one.²⁶ During the first sixty days after a set of 16(a) reports are available, the corporation would have the sole power to act. No services performed during this period by a shareholder's attorney would be compensable. Such a period would properly place the primary burden for enforcement on the corporation. Furthermore, the sixty-day length of this period would appear reasonable in light of the present congressional enactment which sets out sixty days as ample time for a corporation to act once a shareholder's request has been presented to it. If, by the expiration of the first period the corporation had not brought suit or procured a settlement, then a shareholder's attorney would be permitted to investigate for 16(b) violations. Upon discovery of a violation and presentation of the statutory request, such shareholder's attorney would be entitled to a set sum for counsel fees. Also upon presentation of the request the second sixty-day period would begin to run. If, after thirty days from the date of the request the corporation still had not brought suit or procured a settlement, the shareholder's attorney would be permitted to draft a complaint and recover for his expenses. The thirty-day period again would seem reasonable since 16(a) reports would have been available for at least ninety days. Finally, if the corporation had not brought suit within sixty days of the request, the shareholder's attorney might do so.

Compared with the "substantial period" test, the suggested alternative would provide superior enforcement. Generally, enforcement would be accelerated by nearly two years under the alternative. Although outside enforcement would be delayed sixty

²⁶ Professor Loss has suggested that the section be amended to provide for enforcement by the SEC rather than the issuer or its shareholders. 2 Loss at 1053-55. However, the commission is understandably reluctant to enter the field. Professor Cary, former chairman of the commission, has argued that self-enforcement has been effective and is preferable to governmental intervention. See Cary, *Recent Developments in Securities Regulation*, 63 COLUM. L. REV. 856 (1963).

days longer than under the present *statutory* scheme, the present case law encourages delay in most instances until shortly before the two-year statute of limitations expires.²⁷ Duplication would persist under the alternative, but corporations, the parties ordinarily pleading duplication as a reason for termination of outside enforcement, would be given every opportunity to prevent it: there are no less than three stages in every case where a corporation could assume responsibility for the enforcement of 16(b) and bring an end to further duplication. Profiteering also would be impossible to halt completely so long as outside enforcement is necessary, but by giving corporations several opportunities to step in without penalizing outside attorneys for work already completed, the external stimulus still would be encouraged, yet the corporation would be constantly urged to enter and limit the outsider's profit. The key to control of the unethical aspects of outside enforcement is careful regulation of the initial fee attorneys may recover for mere discovery before a corporation is on notice and can stop further shareholder action. With a set initial fee the outsider would have no opportunity to pad the bill for discovery, and the unscrupulous would not be attracted to 16(b) enforcement. Unfortunately, however, there seems to be no way to guarantee slower and better-reasoned research by any attorney. Still the 120-day period would remove the speed factor from 16(b) enforcement while not causing serious delay. Finally, and perhaps most important, the standards of the alternative are concrete. It would, if enacted, inject some certainty into the law, putting both the shareholder and the corporation on notice as to how each might satisfy the statutory requirements.

²⁷ See note 20 *supra* and accompanying text.