

RECENT DEVELOPMENTS

SECURITIES REGULATION: SECTION 16(b) SHORT-SWING PROFIT LIABILITY APPLICABLE TO STOCK PURCHASED DURING DIRECTORSHIP BUT SOLD AFTER RESIGNATION

In *Feder v. Martin Marietta Corp.*¹ the Court of Appeals for the Second Circuit found Martin Marietta Corporation liable under Section 16(b) of the Securities and Exchange Act of 1934² for short-swing profits realized on the sale of stock of Sperry Rand Corporation, purchased while Martin Marietta's president was on the Sperry board of directors and sold after he resigned that directorship. Martin Marietta had purchased 700,000 shares of Sperry Rand during the period from December 14, 1962, through April 29, 1963, on which date Martin Marietta's president, George Bunker, was named to Sperry Rand's board of directors. Until Bunker's resignation on August 1, 1963, Martin Marietta accumulated an additional 101,300 shares. Thereafter Martin Marietta sold all of its Sperry Rand stock between August 29, 1963 and September 6, 1963. The plaintiff shareholder subsequently commenced a derivative action on behalf of Sperry Rand alleging that Bunker was deputized by, or represented, Martin Marietta during his Sperry Rand directorship and that Martin Marietta's resulting "director" status obligated it to return to Sperry Rand the short-swing profit realized on the sale of the 101,300 shares which had been purchased during the Bunker/Martin Marietta directorship. The district court found that Martin Marietta had not deputized Bunker to represent its interests on Sperry Rand's board of directors,³ but the Second Circuit reversed, finding the district court conclusion "clearly erroneous" with regard to the facts and inferences concerning Bunker's deputization.⁴ Moreover, the court

¹ 406 F.2d 260 (2d Cir. 1969).

² 15 U.S.C. § 78p(b) (1964).

³ *Feder v. Martin Marietta Corp.*, 286 F. Supp. 937, 948 (S.D.N.Y. 1968).

⁴ 406 F.2d at 263.

held that even though the sale was made after Bunker's resignation, Martin Marietta was liable for profits made on stock purchased while he was a director and sold within six months of purchase.⁵

Section 16 of the Securities and Exchange Act of 1934⁶ was enacted to curtail the widespread practice of insiders using information obtained by virtue of their relationship to a corporation to profit in short-swing trading in the corporation's stock.⁷ The major impact of section 16 is contained in subsection (b) which provides that "such beneficial owner, director, or officer" shall be liable to the issuer for any profit he realizes on a purchase or sale, or sale and purchase of the equity securities of the issuer within a period less than six months.⁸ It is usually stated that the words "such beneficial owner, director, or officer" refer to the description in subsection (a), which states the reporting requirements of section 16.⁹ Section 16(a) requires "[e]very person who is directly or indirectly the beneficial owner of more than 10 per centum of any class of any equity security . . . or who is a director or an officer of the issuer of such security . . ." to file an initial statement of the amount of his ownership of stock in the issuer and to file subsequent reports after every month in which there is a change in his ownership.¹⁰ Because the statute is aimed at possible rather than proven misuse of inside information¹¹ and because section 16(b) exposes the insider to mere remedial civil liability in favor of the issuer,¹² liability for short-swing profit is imposed expressly irrespective of intent to profit.¹³ In reconciling the literal meaning of the statute with its broad prophylactic

⁵ *Id.* at 269.

⁶ 15 U.S.C. § 78p (1964).

⁷ See H.R. REP. NO. 1383, 73d Cong., 2d Sess. 13 (1934); 2 L. LOSS, *SECURITIES REGULATION* 1037-38 (2d ed. 1961); Cook & Feldman, *Insider Trading Under the Securities Exchange Act*, 66 HARV. L. REV. 385, 612 (1953).

⁸ 15 U.S.C. § 78p(b) (1964). See generally 2 L. LOSS, *SECURITIES REGULATION* 1058-1121 (2d ed. 1961).

⁹ See H. BLOUMENTHAL, *SECURITIES LAW* 366 (1966).

¹⁰ 15 U.S.C. § 78p(a) (1964) (initial report must be filed at time of security's registration or within ten days of becoming beneficial owner, director or officer, and subsequent reports must be filed within ten days after the close of any calendar month in which a change in ownership occurs). See generally 2 L. LOSS, *SECURITIES REGULATION* 1037-58 (2d ed. 1961).

¹¹ See *Smolowe v. Delendo Corp.*, 136 F.2d 231, 235-36 (2d Cir.), cert. denied, 320 U.S. 751 (1943).

¹² See *Adler v. Klawans*, 267 F.2d 840, 844-45 (2d Cir. 1959).

¹³ 15 U.S.C. § 78p(b) (1964).

purpose, however, the courts have encountered certain problem areas in which it has been impossible to ignore completely the insider's subjective intent.¹⁴ One such area is where the insider is a partner in a broker-dealer firm, and the partnership engages in short-swing transactions.¹⁵ In *Blau v. Lehman*¹⁶ the Supreme Court noted that a broker-dealer partnership would be considered a "director" within the meaning of section 16(b) if it were represented on an issuer's board of directors by a "deputy."¹⁷ In *Blau* the plaintiff argued that defendant Lehman Brothers was required to disgorge short-swing profits made on transactions in stock of the Tidewater Oil Company, since a Lehman Brothers partner was on the Tidewater board of directors.¹⁸ The Supreme Court affirmed the lower court findings¹⁹ that the partner was not on the Tidewater board in order to represent Lehman Brothers' interests and that no inside information was used by Lehman Brothers.²⁰ Noting that the question of deputization is one of fact

¹⁴ See Munter, *Section 16(b) of the Securities Exchange Act of 1934: An Alternative to "Burning Down the Barn in Order to Kill the Rats,"* 52 CORNELL L.Q. 69 (1966); Painter, *The Evolving Role of Section 16(b)*, 62 MICH. L. REV. 649 (1964).

¹⁵ It is generally stated that section 16(b) does not reach "tippee" cases. 2 L. LOSS, SECURITIES REGULATION 1043 (2d ed. 1961). Although early drafts of section 16(b) prohibited insiders from disclosing inside information to outsiders and made the profits of the "tippee" recoverable by the issuer, these provisions were never enacted because of anticipated difficulties of proof. *Hearings on H.R. 7852 and H.R. 8720 Before the House Comm. on Interstate and Foreign Commerce*, 73d Cong., 2d Sess. 133 (1934).

¹⁶ 368 U.S. 403 (1962).

¹⁷ *Id.* at 409-10. See also *Rattner v. Lehman*, 193 F.2d 564, 567 (2d Cir. 1952) (concurring opinion).

¹⁸ 368 U.S. at 404-05.

¹⁹ *Blau v. Lehman*, 173 F. Supp. 590 (S.D.N.Y. 1959), *aff'd*, 286 F.2d 786 (2d Cir. 1960).

²⁰ It is interesting to note that the Supreme Court found actual use of inside information relevant, especially since Mr. Justice Black indicated that 16(b) would not reach the "tippee" cases. 368 U.S. at 411-13. Apparently, however, once the question of "deputization" is decided in the affirmative, intent or actual use of inside information would become irrelevant. See Munter, *supra* note 14, at 80 n.53.

It has been noted that there is a statutory route which would justify the Supreme Court's conclusion that a partnership or corporation may be a 16(b) director. Section 16(b) refers to "any director." Section 3(a)(7), 15 U.S.C. § 78(c)(7) (1964), defines a "director" to include any person performing functions of a director. Section 3(a)(9) of the Act, 15 U.S.C. § 78(c)(9) (1964), defines a "person" to include a partnership or corporation.

The applicability of *Blau* to broker-dealers has been somewhat limited by the 1964 amendments concerning trading for purposes of market making and stabilization. Securities Exchange Act of 1934, § 16(d), added by 15 U.S.C. § 78p(d) (1964); Painter, *Section 16(d) of the Securities Exchange Act: Legislative Compromise or Loophole?*, 113 U. PA. L. REV. 358 (1965).

to be determined in each case, the Court reasoned that Congress could amend section 16(b) if it disapproved of the subjective inquiry incidental to applying the deputization theory.²¹ Another area in which the functional purpose of section 16(b) appears to have prevailed over a literal interpretation has been where the courts have found a director liable for short-swing profits realized on stock purchased before his directorship but sold while he was a director within six months of purchase.²² In supporting such a decision in *Alder v. Klawans*²³ the Second Circuit relied heavily on the provision in section 16(b) that short-swing profit liability shall not be imposed on a "beneficial owner" where he was not such at both the time of sale and purchase.²⁴ This explicit provision was thought to give rise to the implication that a *director* or *officer* would be liable under section 16(b) despite the fact that he did not have such insider status at both the time of purchase and sale.²⁵ The court further noted that section 16(b) is remedial, not penal, and thus a broad interpretation most nearly accords with the legislative purpose.²⁶

In *Feder*, after reviewing the district court's finding that Bunker was not a deputy of Martin Marietta on Sperry Rand's board of directors, the court of appeals stated that it would reverse only if the inferences drawn from the evidence were "clearly erroneous" since the question of deputization was one of fact. Noting the district court's reliance on the fact that Bunker's services were solicited by Sperry Rand for his professional expertise, the court indicated that, though not determinative, more weight should have been accorded to the fact that Bunker was chief executive of Martin Marietta and had the ultimate control of investment decisions.²⁷ The court distinguished *Blau v. Lehman* on the grounds

²¹ 368 U.S. at 412-13 (noting that congressional amendments could have disavowed the deputization theory when it was first articulated in *Rattner v. Lehman*, 193 F.2d 564 (2d Cir. 1952)).

²² See *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*, 163 F. Supp. 702 (S.D.N.Y. 1958).

²³ 267 F.2d 840 (2d Cir. 1959).

²⁴ *Id.* at 845. Despite this provision the Second Circuit in *Stella v. Graham-Paige Motor Corp.*, 232 F.2d 299 (2d Cir.), *cert. denied*, 352 U.S. 831 (1956), held a beneficial owner can be liable under 16(b) where the purchase in issue was the one that made him a 10% owner.

²⁵ 267 F.2d at 845.

²⁶ *Id.* at 844. See *Munter*, *supra* note 14.

²⁷ 406 F.2d at 264.

that in that case the partner, who was found not to have imparted inside information to the broker-dealer firm, "exercised no power of approval concerning the partnership's investment" ²⁸ In view of Bunker's control of Martin Marietta's investments, the court found insignificant "the district court's finding that Bunker 'never disclosed information relevant to investment decisions' and that the 'information he obtained while a director simply wasn't germane to that question at all.' " ²⁹ Moreover, the court found relevant Bunker's letter of resignation, which stated that he had only agreed to be a director because of Martin Marietta's large investment in Sperry Rand, and the fact that Martin Marietta's board of directors did not approve Bunker's directorship of Sperry until after Martin Marietta had substantial investments in Sperry stock. ³⁰ In view of the compelling inferences from the evidence, the court held that the district court had committed a mistake in finding no deputization. ³¹

An additional and perhaps more difficult issue which had to be resolved in order to find 16(b) liability was presented by the fact that Martin Marietta had not sold the Sperry Rand stock until *after* Bunker had resigned his directorship. The defendant relied on rule 16a-10 of the Securities Exchange Commission ³² which releases from 16(b) liability any "transaction" exempted from the section 16(a) reporting requirement. Accordingly, since 16(a) would not apply after a director resigned, ³³ the defendants contended that 16(b) would not apply. Moreover, the defendants argued that in imposing short-swing profit liability on "such beneficial owner, director, or officer," 16(b) is thereby referring to the same type of individual who is subjected to the reporting requirements of 16(a), namely an individual "who *is* . . . [a] beneficial owner . . . a director or an officer . . ." ³⁴ Thus, the defendants contended that the use of the present tense in the 16(a) description made 16(b) literally inapplicable where the transaction occurs after a director

²⁸ *Id.* at 265.

²⁹ *Id.* at 264.

³⁰ *Id.* at 265-66.

³¹ *Id.* at 266.

³² 17 C.F.R. § 240.16a-10 (1968).

³³ See 2 L. LOSS, SECURITIES REGULATION 1061 (2d ed. 1961).

³⁴ 15 U.S.C. § 78p(a) (1964) (emphasis added) (quoted in part in text accompanying note 10 *supra*).

has resigned.³⁵ The court rejected these contentions, however, and held rule 16a-10 invalid to the extent that it would exempt the *Feder* transaction.³⁶ Though noting the plausibility of the defendant's argument upon a literal reading of 16(a) and 16(b), the court directed attention to the Security and Exchange Commission's Form 4,³⁷ which seemed to extend reporting requirements to ex-directors so as to include any transactions occurring in their last month as a director.³⁸ Since Form 4 apparently extended 16(a) coverage, the court reasoned that it must likewise expand potential liability under 16(b).³⁹ However, although the Form 4 ex-director provision was a valid exercise of the Commission's rule-making power, the court reasoned that the effect of the extension on 16(b) was arbitrary in that 16(b) liability could thus depend upon how early in the month a director resigned. Thus, the court concluded, given the SEC's ability to extend the reporting requirements of ex-directors, a less arbitrary extension of 16(b) coverage would seem only logical.⁴⁰ The court further noted that where stock is purchased during the period of insider status and disposed of shortly after the termination of that status, there exists a greater likelihood that both the purchase and sale are motivated by inside information than in the *Adler*-type situation where only the sale could be motivated by inside information.⁴¹ Upon this basis the court held "that § 16(b) applies to a sale of corporate stock by a former director of that corporation if the stock were purchased by him (or purchased by any jurat person that had 'deputized' him) during the time he was a director and the sale was made within six months after purchase."⁴²

After *Feder* the scope of the deputization theory remains unclear. It seems apparent that a deputizing corporation or partnership must file section 16(a) reports. The *Feder* court's focusing on the unique prophylactic aspects of section 16, moreover, indicates that a deputizing corporation or partnership,

³⁵ 406 F.2d at 267.

³⁶ *Id.* at 268.

³⁷ Form 4 is authorized by 17 C.F.R. § 240.16a-1(a) (1968).

³⁸ 406 F.2d at 268.

³⁹ *Id.*

⁴⁰ *Id.* at 269.

⁴¹ *Id.* at 268.

⁴² *Id.* at 269.

which is considered a director for section 16 purposes, might not be considered a director for other purposes such as liability for signing a registration statement. The question less clearly answered by *Feder*, however, is whether a partnership or corporation must have a direct financial investment in the issuer before the partnership or corporation employee, who is a director of the issuer, will be considered to be a deputy. In *Feder* the deputizing firm had a large equity investment in Sperry Rand. Presumably the court would have found sufficient representation of an "interest" for deputization purposes even if Martin Marietta had initially been attempting to protect an investment of *debt* securities in Sperry Rand. If the facts had been different and Martin Marietta had put Bunker on Sperry Rand's board merely with the intent of protecting future investments, then deputization to protect an investment interest could not be found until just after the first purchase of Sperry Rand securities.⁴³ Of course, a court could find deputization without direct financial investment, but this would be tantamount to repudiating the idea that section 16 does not reach the "tippee" case.⁴⁴ Very likely, however, the courts will begin to find deputization under section 16 when the recipient of the insider's tip is the partner or employer of the actual insider, regardless of the nature of the deputizing firm's initial "interest" in the issuer. Furthermore, it would seem that as a practical matter the deputizing corporation usually will be unable to place a deputy on the issuer's board until it has substantial, direct financial investments in the issuer.

In addition to applying the deputization theory, the *Feder* court so extended 16(b) liability that the decision well may portend the day when one-time insiders will be held accountable for short-swing profits reaped up to a year after the termination of their insider status. The Second Circuit's movement in this direction seems more the result of the court's distaste for insider deals, however, than the product of a careful analysis of the Act's express language. For example, in *Feder* the court operated on the seemingly questionable assumption that the Securities and Exchange Commission's Form 4 "governs the reporting provision

⁴³ *Cf.* note 24 *supra*.

⁴⁴ See notes 15 & 20 *supra*.

of § 16(a)⁴⁵ The court noted that Form 4 requires reports by

[e]very person who at any time during any calendar month was . . . a director or officer of . . . the issuer . . . and who during such month had any change in his beneficial ownership of any class of equity securities of such company⁴⁶

Contrary to the court's assumption that Form 4 represents a "proper exercise" of the Commission's rule-making power,⁴⁷ one might be led to the conclusion that it is overly broad. Arguably, the best reading of 16(a) is that it requires a report by any person who was a director during any calendar month *only* if the ownership change took place *during* the existence of insider status.⁴⁸ However, probably in order to expand section 16's impact beyond the narrow, and admittedly equivocal, statutory limits, the court chose to read Form 4 as requiring reporting of all changes during any calendar month in which insider status existed. Once having used Form 4 expansively to interpret section 16(a), however, the court immediately stated that Form 4 was itself "arbitrarily inadequate."⁴⁹ This conclusion was readily acceptable since the impact of section 16 would be avoided by resigning at the end of one calendar month and reaping short-swing profit in the next. Thus, without establishing outside limits, the Second Circuit has held that section 16(b) "putative liability" extends at least as far as the Form 4 reporting requirements, and that Form 4 does not impose sufficiently extensive requirements.⁵⁰

Future cases will determine whether the Second Circuit is actually moving to proscribe transactions taking place up to a year after the termination of insider status. For example, cases will undoubtedly arise in which (1) the director purchases (or sells) prior to assuming his directorship and sells (or purchases) after his resignation, all within six months; (2) an ex-director both purchases and sells within six months after his resignation; or (3) an ex-director

⁴⁵ 406 F.2d at 268.

⁴⁶ *Id.* at 267.

⁴⁷ *Id.* at 268.

⁴⁸ See 15 U.S.C. § 78p(a) (1964). Form 4 interprets 16(a) to require reporting of *any* change in ownership which occurs during a calendar month in which the individual was at any time a director.

⁴⁹ 406 F.2d at 269.

⁵⁰ *Id.*

purchases (or sells) within six months of resignation and *thereafter* reaps short-swing profit. These cases are distinguishable from *Adler* and *Feder* which both involved at least one transaction that occurred during the directorship. However, the underlying rationale of both *Adler* and *Feder* might lead to a finding of director liability in the first suggested case since the transaction subsequent to termination could have been motivated by inside information. Therefore, liability might also be found in the second suggested case since it is entirely possible for a director to have meaningful inside information six months after resignation. Moreover, such reasoning would undoubtedly bring about liability in the third suggested case. The *Feder* court ignored the possibility of such extensions but it also did *not* suggest that it intended to limit liability to situations in which at least one of the transactions takes place within the insider period. Though the latter approach would be in accord with the mechanical nature of 16(b), it would not necessarily effectuate what the Second Circuit feels to be the underlying purpose of the Act. This can be shown by contrasting two possible short-swing situations. Consider first the director in corporation *A* who resigns and within the following calendar month purchases and sells large amounts of *A* stock. Certainly these transactions could have been, and most likely were, motivated by inside information obtained by the ex-director while he was a director. However, under the "mechanical" interpretation, 16(b) would not apply since neither transaction occurred during the insider period. Contrasted to this situation is the one where a director in corporation *A* purchases *A* stock the day before he resigns and sells five and one-half months later. In this case 16(b) would apply though it is less probable that inside information was used in this case than in the former situation. The Second Circuit's opinion in *Feder* has set the basis for expansion of 16(b). It seems that the court prefers to use a broad interpretation of section 16, which imposes "mechanical" strict liability, rather than using a literal interpretation and relying upon those other securities regulation provisions⁵¹ which necessitate a true ascertainment of whether inside information has been misused.

⁵¹ E.g., Securities Act of 1933, § 12(2), 15 U.S.C. § 77l(2) (1964); Securities Act of 1933, § 17(a), 15 U.S.C. § 77q(a) (1964); Rule 10b-5 of the Securities Exchange Commission, 17 C.F.R. § 240.10b-5 (1968).