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Section 16(b): Blau v. Lamb--Purchase and Sale as an Indicator of Judicial Trends

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SECTION 16(b): *BLAU V. LAMB*[1]—"PURCHASE" AND "SALE" AS AN INDICATOR OF JUDICIAL TRENDS

INTRODUCTION

Ideally the securities markets serve three functions: (1) to provide ready marketability for corporate and municipal securities; (2) to provide prices for securities commensurate with their investment value; and (3) to provide a medium for the efficient channeling of the nation's capital into productive economic development.[2] It is perhaps the latter function which justifies the very existence of organized security exchanges.[3]

However, prior to 1929 and during the ensuing economic depression, the national exchanges failed to fulfill these basic functions. One of the major causes for this breakdown was the widespread manipulation of security prices by organized pools created specifically for quick monetary gain.[4] Congressional inquiries conducted during 1933 and 1934 disclosed not only that professional traders were involved in the manipulative pools, but also that many corporate insiders were active partners in pools organized to control the securities of their own corporation.[5] Also disclosed by the inquiries was the less sophisticated, but equally profitable, practice of officers and directors of corporations unscrupulously capitalizing on the employment of information obtained by their inside position.[6] The result

1 Civil No. 29940, 2d Cir., June 27, 1966.

2 TWENTIETH CENTURY FUND, THE SECURITY MARKETS 19-32 (1935).

3 *Id.* at 32. The picture is not complete until it is considered that the organized exchanges have a substantial influence on the investment capital that flows into the multitude of unlisted securities, because, to a certain degree, it is by the action on the organized exchanges that the prices and values of the unlisted securities are determined. BERLE & MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY 297 (1932); see Moore & Wiseman, *Market Manipulation and the Exchange Act*, 2 U. CHI. L. REV. 46 (1934). Thus, when the demand for securities increases on the organized exchanges, this necessarily generates a demand for unlisted securities.

4 S. REP. No. 1455, 73d Cong., 2d Sess. 5 (1934).

5 S. REP. No. 792, 73d Cong., 2d Sess. 9 (1934); S. REP. No. 1455, 73d Cong., 2d Sess. 55-68 (1934).

6 Prior to the enactment of the Securities Exchange Act of 1934, market trading on inside information was probably one of the largest sources of income to management and other insiders. Rubin & Feldman, *Statutory Inhibition Upon Unfair Use of Corporate Information by Insiders*, 95 U. PA. L. REV. 468 (1947). The most profitable form of insider information was generally concerned with the increase, resumption or passing of dividends. Cook & Feldman, *Insider Trading Under the Securities Exchange Act*, 66 HARV. L. REV. 385, 386 (1953). See S. REP. No. 792, 73d Cong., 2d Sess. 9 (1934), for glaring examples of the profitable use of such information. The profits derived from this type of "sure thing" speculation were generally considered a part of the compensation for serving as an officer or director of a corporation. 2 LOSS, SECURITIES REGULATION 1037 (2d ed. 1961).

There is little doubt that the common law was inadequate to insure an orderly of these practices was a generated speculation; a speculation based not on future worth, but rather an excessive and irrational speculation that ultimately disrupted the flow of credit and dislocated industry.[7]

It was against this background that the Securities Exchange Act of 1934[8] was enacted.[9] Its purpose was to purge the security exchanges of existing abuses[10] and to secure the restoration of business confidence and the return of investment capital.[11] Basically, the Securities Exchange Act of 1934

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securities market. See Yourd, *Trading in Securities by Directors, Officers and Stockholders: Section 16 of the Securities Exchange Act*, 38 MICH. L. REV. 133, 143-44 (1939). The problem was too large and the remedies provided placed an almost unsurmountable burden of proof upon the injured shareholder. The strict common law rule, as applied in the majority of the state courts, held that there was no fiduciary obligation between the officers and directors of a corporation and its shareholders. See the leading case of Carpenter v. Danforth, 52 Barb. 581 (N.Y. 1868). It was felt that if buyers and sellers dealt at arm's length through the medium of a securities market, each party should be free to determine for himself his best course of action. Goodwin v. Agassiz, 283 Mass. 358, 186 N.E. 659 (1933). Even under the exceptions to this rule, *i.e.*, the special facts doctrine enunciated in Strong v. Repide, 213 U.S. 419 (1909), and the fiduciary or minority rule enunciated in Oliver v. Oliver, 118 Ga. 362, 45 S.E. 232 (1903) and Stewart v. Harris, 69 Kan. 498, 77 Pac. 277 (1904), the duty recognized failed to curb many of the abuses because the limited duty imposed extended only to those who were already shareholders. See Cook & Feldman, *supra* at 408-10.

7 S. REP. No. 792, 73d Cong., 2d Sess. 3 (1934). S. REP. No. 1455, 73d Cong., 2d Sess. 5 (1934).

8 The necessity for the regulation of the securities exchanges is set forth in § 2 of the act:

> . . . transactions in securities as commonly conducted upon securities exchanges and over-the-counter markets are affected with a national public interest which makes it necessary to provide for regulation and control of such transactions . . . in order to protect interstate commerce, the national credit, the Federal taxing power, to protect and make more effective the national banking system and Federal Reserve System, and to insure the maintenance of fair and honest markets . . . .

15 U.S.C. § 78b (1964).

9 Prior to the Great Depression, the security markets were largely unregulated by the Government and consequently the participants in the market were left to their own moral standard. This is not to say that regulation was not considered and attempted. The 1907 panic led to a state investigation in New York while the depression of 1913 set off a congressional investigation. However, in both of these economic setbacks prosperity quicky returned to the nation and for the most part the matter of regulation was forgotten. The depression of 1920 led to another congressional inquiry which resulted in limited federal regulation of the grain markets. With this background, there is little doubt that the federal investigations which followed the Great Depression of 1929 would have had simliar results had the economic conditions not worsened. See Hanna, *The Securities Exchange Act of 1934*, 23 CALIF. L. REV. 1, 10 (1934).

10 S. REP. No. 792, 73d Cong., 2d Sess. 9 (1934); S. REP. No. 1455, 73d Cong., 2d Sess. 68 (1934). See Moore & Wiseman, *supra* note 3, at 46-47, where the authors state the objectives of the act to be threefold: (1) curb excessive speculation, (2) provide adequate information to the investing public, and (3) prevent the manipulation of stock prices.

11 H.R. REP. No. 1383, 73d Cong., 2d Sess. 13 (1934); S. REP. No. 1455, 73d Cong., 2d Sess. 81 (1934).

provides for the disclosure of material facts to the public, for the control of fraud and manipulation in securities trading, for the regulation of the securities markets, and for the control of credit that may be extended for investments in the markets.[12] Section 16 of the act[13] provides for insider[14] disclosures and the control of manipulation in insider trading. Specifically, section 16(a) requires periodic disclosure of the insider's trading activities in the stock of his own corporation.[15] Section 16(b) provides that any profits inuring to an officer, director or ten percent beneficial owner from any "purchase" and "sale" or any "sale" and "purchase" of an equity security of the corporation within any six month period is recoverable by the corporation *irrespective* of any intent of the insider.[16] Section 16(c) prohibits the

12 1 LOSS, SECURITIES REGULATION 130-31 (2d ed. 1961); TWENTIETH CENTURY FUND, *op. cit. supra* note 2, at 702.

13 15 U.S.C. § 78p (1964).

14 The term "insider" as used hereinafter refers to any person who is directly or indirectly the beneficial owner of more than ten percent of any class of equity security or who is an officer or director of the issuer of any equity security. See 15 U.S.C. § 78p(a) (1964); note 15 *infra.*

15 15 U.S.C. § 78p(a) (1964). This provision states:

> Every person who is directly or indirectly the beneficial owner of more than 10 per centum of any class of any equity security (other than an exempted security) which is registered pursuant to section 78 of this title, or who is a director or an officer of the issuer of such security, shall file, at the time of the registration of such security on a national exchange or by the effective date of a registration statement filed pursuant to section 78(g) of this title, or within ten days after he becomes such beneficial owner, director, or officer, a statement with the Commission . . . of the amount of all equity securities of such issuer of which he is the beneficial owner, and within ten days after the close of each calendar month thereafter, if there has been a change in such ownership during such month, shall file with the Commission . . . a statement indicating his ownership at the close of the calendar month and such changes in his ownership as have occurred during such calendar month.

Ibid.

It was felt that if the trading activities of the insider were made public, the practice of using inside information for personal gain would be discontinued. Cook & Feldman, *supra* note 6, at 386.

16 15 U.S.C. § 78p(b) (1964). The pertinent portion of this section 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 . . . within any period of less than six months, unless such security was acquired in good faith in connection with a debt previouly 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 . . . .

Ibid.

This provision is, of course, the true deterrent to insider short swing trading. If all possibility for profit is removed, there remains no motive to enter into such a transaction. See Cook & Feldman, *supra* note 6, at 387.

insider from short selling and selling against the box.[17] It is section 16(b) that serves as the "blunt instrument" to deter the insider from the use of information he may have obtained by reason of his position. This section was not intended to be penal in nature and has been correctly interpreted by the courts to be remedial.[18] But despite this remedial interpretation, the earlier court decisions applied a harsh rule. In *Smolowe v. Delendo Corp.*,[19] the first significant judicial decision interpreting section 16(b), the court concluded that:

> the statute was intended to be thorough-going, to squeeze all possible profits out of stock transactions, and thus to establish a standard so high as to prevent any conflict between the selfish interest of a fiduciary officer, director, or stockholder and the faithful performance of his duty.[20]

It was admitted that bona fide transactions may be "caught in the net of the Law" but the court felt it was a small price to pay for an objective measure of proof[21] and a simple cause of action.[22]

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17 15 U.S.C. § 78p(c) (1964).

18 *E.g.*, Ellerin v. Massachusetts Mut. Life Ins. Co., 270 F.2d 259 (2d Cir. 1959).

19 136 F.2d 231 (2d Cir.), *cert. denied*, 320 U.S. 751 (1943).

20 *Id.* at 239.

21 The Securities Exchange Act does provide an exemption that rests upon a subjective measure of proof. Liability for profits realized may be avoided if "such security was acquired in good faith in connection with a debt previously contracted." 15 U.S.C. § 78p(b) (1964). This exemption was first considered in Smolowe v. Delendo Corp., *supra* note 20, where a stock acquisition by the debtor insider to discharge a debt was held not within the meaning of the exemption. However, the stock received by the creditor was exempt because to hold otherwise would deprive the creditor of the payment benefits. This defense has been pleaded, and rejected, in almost all reported cases. *E.g.*, Park & Tilford v. Schulte, 160 F.2d 984, 987 (2d Cir.), *cert. denied*, 332 U.S. 761 (1947). It was accepted in one other case. In Rheem Mfg. Co. v. Rheem, 295 F.2d 473 (9th Cir. 1961), the defendant elected to receive his retirement bonus in corporate stock. The defendant pledged the stock and it was subsequently sold by the defendant's pledgee within six months. In considering the good faith of the defendant, the court said that the election to accept stock rather than cash, insurance or annuities was but one factor to be considered in determining the defendant's good faith. The *Rheem* decision appears well within the *Smolowe* interpretation of what is a debt previously contracted; however, it has extended the application of this exemption when contrasted with the "stock option" case of Truncale v. Blumberg, 80 F. Supp. 387 (S.D.N.Y. 1948). In *Truncale* the defendant was issued warrants to purchase the company's stock as part consideration for his employment. The court held the acquisition of the warrants not within the statutory exemption. It would seem there is little difference between an acquisition of warrants and an acquisition of stock when they are both issued for prior services. But the obligation was held not to be a debt within the meaning of § 16(b) in *Truncale* while it was held to be one in *Rheem*.

22 Undoubtedly, the simplicity of § 16(b) and its objective burden of proof has been a substantial deterrent to short swing trading. However, the number of cases involving § 16(b) does not give an accurate guide to the number of actual recoveries that have taken

The purpose of this Note is to determine the trends in judicial interpretation of section 16(b) of the Securities Exchange Act of 1934.[23] The courts' treatment of the terms "purchase" and "sale" as defined by the act has been chosen as the criteria for two reasons. First, the interpretation of these terms has been the most litigated aspect of section 16(b). Second, the recent influx of cases arising under this section has been concerned primarily with an interpretation of these terms. For clarity, the analysis of the cases has been divided into four categories: (1) conversion transactions; (2) gifts and other dispositions; (3) reclassification, reorganization and other exchanges; and (4) put and call options.

II. Purchase and Sale

The Securities Exchange Act broadly defines the terms "purchase" and "sale." Thus, "the terms 'buy' and 'purchase' each include any contract to buy, purchase, or otherwise acquire"[24] and "the terms 'sale' and 'sell' each include any contract to sell or otherwise dispose of."[25] Obviously such ambiguous and vague terminology can include almost any acquisition or disposition of securities. However, whether or not a given transaction falls within section 16(b) depends mainly on a judicial determination of statutory purpose and not on any concept of plain meaning.[26]

A. *Conversion Transactions*

A conversion transaction involves the exchange of one security for another security. Typical of such a transaction is the exchange of convertible preferred stock of a corporation for common stock in the same corporation at a predetermined conversion rate. Generally, the option to convert is held by the convertible security holder; however, frequently the issuing corporation has reserved the right to terminate the conversion option after a certain date. The leading case interpreting the terms "purchase" and "sale" as applied to a conversion transaction is *Park & Tilford, Inc. v. Schulte*.[27] The defendants were trustees of a family trust which held a controlling interest in the common and convertible preferred stock of the plaintiff corporation. The corporation gave notice of redemption to all preferred stock shareholders. The defendants converted their preferred

place under the provision. Many recoveries go unrecorded as an insider recognizes he has no alternative but to give up his short swing profits. 2 Loss, *op. cit. supra* note 6, at 1043.

23 15 U.S.C. § 78p(b) (1964).

24 15 U.S.C. § 78c(a)(13) (1964).

25 15 U.S.C. § 78c(a)(14) (1964).

26 *E.g.*, Shaw v. Dreyfus, 172 F.2d 140 (2d Cir.), *cert. denied*, 337 U.S. 907 (1949). *But see* Western Auto Supply Co. v. Gamble-Skogmo, Inc., 348 F.2d 736 (8th Cir. 1965), *cert. denied*, 382 U.S. 987 (1966).

27 160 F.2d 984 (2d Cir.), *cert. denied*, 332 U.S. 761 (1947).

stock to common stock and within six months sold the conversion securities. The court held the conversion constituted a purchase of the common stock and imposed liability for the profit realized. It was reasoned that the defendants did not own the common stock before the conversion, but they did own it after the conversion, and thus, the transaction came clearly within the statute which defines purchase to include "any contract to buy, purchase or otherwise acquire."[28] The court refused to entertain the defendant's forced conversion theory because the evidence showed the defendants had complete control of the plaintiff corporation and could have prevented the passage of the redemption resolution, or rescinded it after its passage. This decision clearly followed the approach taken in *Smolowe v. Delendo Corp.*[29] and laid the groundwork for the so-called "objective or dogmatic" approach to conversion transactions.

The other line of authority, or the subjective approach, is derived from the Sixth Circuit case of *Ferraiolo v. Newman.*[30] The defendant, a director of Ashland Oil and Refining Co., acquired convertible preferred stock in Ashland. About three years later, the corporation gave notice of redemption of all outstanding convertible preferred. To prevent a nine dollar per share loss, the defendant converted his preferred stock to common stock and within six months sold a part of the common stock received in the transaction. The court rejected the plaintiff's contention that the conversion constituted a purchase of the common stock within the meaning of section 16(b). It was reasoned that the conversion was involuntary because of the financial loss the defendant would have incurred had he not converted his stock. Also, the court was impressed that the defendant was inactive as a director, and had little control over the management of the corporation. Of secondary importance was the fact that the conversion privilege was undilutable and both the convertible securities and the conversion securities were readily marketable which made them economic equivalents. These circumstances, the court concluded, made the transaction one which could not have lent itself to the practices section 16(b) was enacted to prevent.

Although it has been said the *Park & Tilford* decision stands for the objective approach and the *Ferraiolo* decision represents the subjective approach,[31] this is probably an oversimplification. The court in the *Ferraiolo* case definitely took a more pragmatic view in its application of section

28 15 U.S.C. § 78c(a)(13) (1964).

29 136 F.2d 231 (2d Cir.), *cert. denied*, 320 U.S. 751 (1943).

30 259 F.2d 342 (6th Cir. 1958), *cert. denied*, 359 U.S. 927 (1959); 72 HARV. L. REV. 1392 (1959); 11 STAN. L. REV. 358 (1959); 36 U. DET. L.J. 343 (1959); 107 U. PA. L. REV. 719 (1959); 45 VA. L. REV. 123 (1959).

31 See Heli-Coil Corp. v. Webster, 352 F.2d 156, 161-62 (3d Cir. 1965); Blau v. Lamb, 242 F. Supp. 151, 156 (S.D.N.Y. 1965), *rev'd in part*, Civil No. 29940, 2d Cir., June 27, 1966.

16(b), but the *Park & Tilford* case does not represent a true dogmatic approach because the court considered the defendants' forced conversion theory as a valid issue. This consideration of the defendants' forced conversion theory in the *Park & Tilford* decision must modify the court's otherwise dogmatic rationale. This modification became positive case law in *Ferraiolo* which seemingly represented the ideal factual situation for narrowing the *Park & Tilford* doctrine.

It was not until 1965, in the Ninth Circuit case of *Blau v. Max Factor & Co.*,[32] that the courts again considered the purchase and sale issue in a conversion transaction. In this case, the corporation had two classes of common stock, Class A and Common. Both classes had equal voting rights, similar rights on liquidation, both were fully transferable and neither class was subject to redemption. The board of directors had the power to declare a lesser dividend on the Common than the Class A. The defendants, who owned a controlling interest in the corporation, converted their Common into Class A and within six months sold the converted securities. In holding the conversion not to be a purchase within section 16(b), the court reasoned that the "exchange of . . . [Common for Class A] . . . did not interrupt the continuity of appellee's investment: it did not increase or decrease the amount invested, or alter in any way the risk assumed long years before."[33] Despite the change in terminology, *i.e.*, economic equivalence to continuity of investment risk, the *Max Factor* decision closely followed the rationale of *Ferraiolo*. However, the facts in *Max Factor* gave the defendants a much stronger case than could have been made in either *Park & Tilford* or *Ferraiolo*. An exchange of one equity security for another equity security within the *Max Factor* situation is more defensible under any interpretation of section 16(b) than an exchange of a hybrid security for an equity security. Convertible preferred stock simply represents a different investment than common stock because a convertible preferred security combines some characteristics of an equity security and some characteristics of a debt security. Thus, it may well be that the facts presented in *Max Factor* would have precluded liability even had the *Park & Tilford* court decided the case.

Although apparently rejected by the Ninth Circuit, the *Park & Tilford* objective approach was adopted by a district court in the Eighth Circuit. In *Petteys v. Northwest Air Lines, Inc.*,[34] the plaintiff corporation called its outstanding convertible preferred stock for redemption. The defendants, directors of the corporation, converted their preferred stock to common

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[32] 342 F.2d 304 (9th Cir.), *cert. denied*, 382 U.S. 892 (1965); 26 U. PITT. L. REV. 870 (1965).

[33] Blau v. Max Factor & Co., 342 F.2d 304, 308 (9th Cir.), *cert. denied*, 382 U.S. 892 (1965).

[34] 246 F. Supp. 526 (D. Minn. 1965).

stock which they sold within six months. The court rejected the defendants' contention that since the preferred stock was protected against dilution and closely followed the price of the common stock, the securities were economic equivalents. The forced conversion doctrine was also rejected even though the defendants did not control the corporation. The court reasoned that regardless of whether the defendants acquired the common stock by conversion or purchase, the sale of the common stock was voluntary and led to short term profits which section 16(b) prohibits. In *Petteys* the defendants had a stronger case than was presented in *Park & Tilford* because the defendants in *Petteys* did not have control of the corporation and the conversion was forced as the preferred stock was called for redemption. *Petteys* offered a situation that was ideal for the application of the forced conversion rule laid down in *Ferraiolo,* but this contention was flatly rejected by the court. Further, the economic equivalence rationale which was of primary importance in *Max Factor,* and of secondary importance in *Ferraiolo,* was similarly rejected.

Later in 1965, the Third Circuit rendered its first decision concerning a conversion transaction under section 16(b). In *Heli-Coil Corp. v. Webster,*[35] the defendant, a director of the plaintiff corporation, purchased plaintiff's convertible debentures. The debentures were convertible at the holder's option and callable by the corporation at any time. Within six months the defendant converted the debentures and about eight months after the original debenture acquisition, the conversion securities were sold. The court held the conversion to be a *sale* of the debentures and a *purchase* of the conversion securities. The court reasoned that Congress had intended an objective test and purported to follow the standards set forth in *Park & Tilford.* The argument that the securities involved were economic equivalents was rejected because this was a situation in which there was a trading advantage in holding the common stock rather than the debentures. The standards that were applied by the court went far beyond the approach taken in *Park & Tilford.* By way of dictum, the court indicated that the only transactions that could escape the operation of section 16(b) are those expressly exempt by the statute itself or by the Commissioner of the Securities & Exchange Commission. This dictum is consistent with the overtones of the court that even the coerced conversion theory, the exemption probably provided in *Park & Tilford* and expressly adopted in *Ferraiolo,* would not constitute a valid defense. While the court did justify its decision under the economic equivalent theory, it did not indicate in any way that it agreed with the reasoning of the doctrine.

In 1966, the Second Circuit rejected the *Park & Tilford* rationale and adopted the more subjective approach taken in *Max Factor* and *Ferraiolo.*

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35 352 F.2d 156 (3d Cir. 1965).

In *Blau v. Lamb*,[36] the defendants, insiders in Air-Way Industries, acquired convertible preferred stock in Air-Way and within three months exercised their option to convert the preferred stock to common stock. It was held that the conversion was not a sale within the meaning of section 16(b).[37] It was said that, ". . . in order to avoid 'purposeless harshness' a court should first inquire whether a given transaction could possibly tend to accomplish the practices section 16(b) was designed to prevent."[38] Thus, the court refused to apply section 16(b) unless the transaction could, under any set of circumstances, serve as a vehicle for unfair insider trading. The district court in *Lamb*[39] had held the defendants liable primarily for two reasons. First, the involuntariness of the conversion that was so critical in the *Ferraiolo* case was not present because the defendants were in full control of the corporation. Second, the defendants had acquired different risks and advantages by the conversion because the common stock had greater voting rights, dividends and marketability than the preferred stock.[40] The Second Circuit, however, refused to consider these factors determinative of the real issue in the case, *i.e.*, whether the transaction in any way made possible the unfair insider trading the section was designed to prevent. Under the rationale of *Lamb*, a plaintiff seeking to recover profits under section 16(b) will have to show that the transaction could have been used for advantageous short swing trading. As such, the decision clearly departs from the rationale of *Park & Tilford*. Perhaps more important, however, is the court's refusal to follow the earlier decisions which found certain factors to be important such as: (1) voluntariness of the conversion, (2) lack of the defendant's control of the corporation, and (3) economic equivalence of the securities involved.[41] Thus, the *Lamb* court adopted a rationale that is perhaps even more subjective than that announced in *Ferraiolo*.[42]

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36 Civil No. 29940, 2d Cir., June 27, 1966.

37 The Securities Exchange Commission urged a similar result but on the ground that, although there was a sale of the Air-Way preferred, there was no profit realized. *Id.* at n.25.

38 Blau v. Lamb, Civil No. 29940, at 2408, 2d Cir., June 27, 1966.

39 Blau v. Lamb, 242 F. Supp. 151 (S.D.N.Y. 1965); 17 S.C.L.Q. 620 (1965).

40 Although the district court found the defendants liable for the profits realized, it used the more subjective approach of *Ferraiolo* in reaching its decision.

41 For example, the court in *Max Factor* considered the economic equivalence of the securities involved and the continuity of the defendants' investment important factors in deciding the applicability of § 16(b). Likewise, the *Ferraiolo* decision has been cited for the propositon that the defendants' control of the corporation has a great bearing upon the insider's liability. Petteys v. Northwest Air Lines Inc., 246 F. Supp. 526 (D. Minn. 1965). See also Roberts v. Eaton, 212 F.2d 82 (2d Cir.), *cert. denied*, 348 U.S. 827 (1954) where the court reasoned that the cumulative effect of several factors established that § 16(b) *should not* be applied to the transaction in question.

42 *But see* Blau v. Lamb, Civil No. 29940, n.15, 2d Cir., June 27, 1966. The court stated that the absence of insider control does not totally explain *Ferraiolo*. Instead, the rule of that case is that § 16(b) need not be applied to every transaction described in

There was once a mild conflict in the governing rationale used in the conversion cases. The more objective approach was represented by the *Park & Tilford* case while the later *Ferraiolo* decision began the subjective reasoning. However, in the last few years, this conflict has grown. On the one hand, there are the truly dogmatic decisions in *Heli-Coil* and *Petteys* while the recent *Lamb* decision has clarified the more subjective rationale advanced in *Ferraiolo.* It is interesting to note that the Second Circuit's decision in *Lamb* has, by implication, discredited its prior decisions in *Smolowe* and *Park & Tilford* while the rationale of these earlier cases has been adopted and even broadened in the *Heli-Coil* and *Petteys* decisions.

B. *Gifts and Other Dispositions*

In 1948 a federal district court raised eyebrows by holding, in *Truncale v. Blumberg,*[43] that a gift of warrants to bona fide charities did not constitute a sale within the meaning of section 16(b). The court thought it as absurd to consider these gifts sales as it was to think the defendant donor had realized a profit from the transaction.[44] In dictum the court went further saying that it could not see why a bona fide gift to a relative or employee would not come within this rule unless the donee was, in effect, the alter ego of the donor.[45] In a later case[46] arising out of the same controversy, this dictum was picked up and applied without independent examination of the statute in a situation in which a non-charitable donee sold the gift securities within six months from the time they were acquired by the donor. One year later the Second Circuit considered a similar non-charitable gift situation. In *Shaw v. Dreyfus,*[47] the defendant, a Celanese Corporation director, received shareholder warrants[48] which he later exercised. He made

its terms, *i.e.,* the same approach taken by the *Lamb* court. Other courts, however, have intimated that *Ferraiolo* stands for the proposition that lack of insider control, along with other factors favorable to the defendant, precludes liability. *E.g.,* Petteys v. Northwest Air Lines Inc., 246 F. Supp. 526 (D. Minn. 1965).

43 80 F. Supp. 387 (S.D.N.Y. 1948).

44 The plaintiff argued that a profit had been realized because of the favorable tax deduction afforded charitable gifts by the federal income tax laws. *Id.* at 390. The court's rejection of this argument has drawn severe criticism. See 10 SYRACUSE L. REV. 296 (1959); 62 HARV. L. REV. 706 (1949).

45 The Securities and Exchange Commission in *amicus curiae* brief suggested two alternatives for treating the non-charitable donee: (1) regard the transfer as a gift but require the donee to stand in the same shoes as the donor, or (2) regard every non-charitable gift as a sale for the purposes of § 16(b). These suggestions were rejected by the court. Truncale v. Blumberg, 80 F. Supp. 387, 392 (S.D.N.Y. 1948); see 59 YALE L.J. 510, 527-30 (1950).

46 Truncale v. Blumberg, 83 F. Supp. 628 (S.D.N.Y. 1949).

47 172 F.2d 140 (2d Cir.), *cert. denied,* 337 U.S. 907 (1949).

48 These warrants were rights to subscribe, at fifty dollars per share, for additional stock on the basis of one share for each ten shares held. The warrants were mailed to

gifts of the shares received to donees who did not dispose of the securities within six months. The court applied the reasoning of the *Truncale* decision holding that a bona fide gift is not a transaction within the meaning of section 16(b). The position taken by *Truncale* and *Shaw* has not lost force by the passage of time. In *Blau v. Albert*,[49] the court denied the defendant's motion for summary judgment saying that while a charitable gift may not be within the accepted meaning of a sale, an issue of fact existed of whether the transaction was a bona fide gift or a mere sham.

It is apparent from these gift cases that it is the nature and relationship of the donee to the donor, rather than the transaction itself, that determines whether the gift transaction is a sale within section 16(b). Under the *Truncale* dictum that was applied in both the second *Truncale* decision and the *Albert* case, the plaintiff must come forth with proof that the gift was not bona fide or that the donee was the alter ego of the donor. This necessarily injects an element of subjective proof into the statute which radically departs from the rationale laid down in *Smolowe* and *Park & Tilford*. Since no appellate court is committed to the *Truncale* dictum, the future of this rule is still in doubt. But this departure from the objective tests does indicate a willingness of the courts to strictly construe section 16(b), at least in a gift situation.

In 1965 the Eighth Circuit was faced with a factual situation that involved an unusual disposition of securities. In *Western Auto Supply Co. v. Gamble-Skogmo, Inc.*,[50] the defendant, an insider in Western Missouri, purchased shares in Western Missouri and within six months entered a consent decree with the government in an anti-trust action which required the defendant to dispose of a substantial block of its Western Missouri stock. In holding that the disposition was a sale within the operation of section 16(b), the court rejected the defendant's argument that the sale was compelled by the impending anti-trust suit. The majority reasoned that the mere pendency of an anti-trust action should not cast a different meaning upon the term sale than its ordinary meaning, that is, a contract between parties to pass rights in property for money. This recent decision represents a complete return to the objective rationale of earlier cases. The court in *Western Auto Supply Co.* completely disregarded the *Ferraiolo* test of whether this was the type transaction the statute sought to proscribe. By

the shareholders on October 9, 1945 and were to expire unless exercised fifteen days later.

49 157 F. Supp. 816 (S.D.N.Y. 1957). The court relied on Shaw v. Dreyfus, 172 F.2d 140 (2d Cir.), *cert. denied*, 337 U.S. 907 (1949), for the controlling law. The defendant pleaded that he had made a charitable donation of the shares of stock; however, the reports filed by the defendant with the SEC pursuant to § 16(a) of the act indicated the transfer as "sales made privately for investment."

50 348 F.2d 736 (8th Cir. 1965), *cert. denied*, 382 U.S. 987 (1966); 50 MINN. L. REV. 970 (1966).

applying the more subjective *Ferraiolo* standards, it could easily be said that the impending anti-trust action, in effect, forced the defendant to dispose of its holdings thus causing the transaction to fall outside the intent of section 16(b). Instead, the court looked to the literal meaning of the statute, a rationale similar to that used in *Heli-Coil* and *Petteys*. In comparing the *Western Auto Supply Co.* decision with the gift cases, the same conclusion would have to be reached. Both have construed section 16(b) by looking more to the plain meaning of the statute rather than to its purpose. This appears so even though the defendants in the gift cases disposed of their securities in a completely voluntary act while the defendant in *Western Auto Supply Co.* had a moving force that made the disposition, if not mandatory, at least highly desirable.[51]

C. *Reclassification, Reorganization and Other Exchanges*

In *Blau v. Hodgkinson*,[52] the first case to pass on the issue of whether an exchange of securities is within section 16(b), a parent corporation absorbed four of its subsidiaries. The defendants, directors of the parent corporation, owned stock in the subsidiaries. Pursuant to the plan for reorganization, the defendants exchanged their stock in the subsidiaries for stock in the parent corporation. Within six months, they sold the securities acquired in the exchange. In holding the receipt of the stock to be a purchase within section 16(b), the court reasoned that the defendants were not obligated to accept stock in the parent in exchange for their subsidiary stock. Instead, the defendants had the alternative of demanding the cash value of their subsidiary stock. But once the defendants accepted the exchanged securities, they received a completely different security from that surrendered. The stock exchanged had a value based on assets and liabilities of four corporations while the securities received had a value based on one corporation. Three years later, the Second Circuit again con-

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51 Of course the motivating factor in the disposal of its Western Missouri stock may have been the favorable sale price. Western Auto Supply Co. v. Gamble-Skogmo, Inc., 348 F.2d 736, 742 (8th Cir. 1965), *cert. denied*, 382 U.S. 987 (1966); see 50 MINN. L. REV. 970 n.36 (1966). On the other hand, the motivating force may have been § 5 of the Clayton Act, which provides that a final judgment or decree resulting from any civil or criminal antitrust action instituted by the government which affirms that a defendant has violated the antitrust laws is prima facie evidence as to all matters necessarily proved in the Government's action; but that the statute does not apply to consent judgments or decrees entered before any testimony has been taken. 38 Stat. 731 (1914), as amended, 15 U.S.C. § 16(a) (1964). Thus, a private litigant, claiming treble damages under the Clayton Act, needs only to prove that the violation caused injury to his business or property, and not the commission of the violation itself. This is a relatively simple burden of proof which might have resulted in substantial recoveries against the defendant had it not entered the consent decree.

52 100 F. Supp. 361 (S.D.N.Y. 1951); 52 COLUM. L. REV. 535 (1952).

sidered the exchange issue in *Blau v. Mission Corp.*[53] and *Roberts v. Eaton.*[54] In the *Mission Corp.* decision, the defendant purchased over ten percent of the stock in Tide Water Associated Oil Company and transferred it to a subsidiary holding company established exclusively to hold the acquired stock. In return, the defendant received two shares of subsidiary stock for each share transferred to the subsidiary. The defendant then declared a dividend to its stockholders with part of the stock received in the exchange. The defendant subsequently purchased more Tide Water stock and within six months made a similar exchange. The court held the first exchange not to be a sale of the Tide Water stock. It was reasoned that the exchange was merely a change in form because the subsidiary was wholly owned by the defendant. However, the second exchange came within section 16(b) because the public ownership of the subsidiary stock made the subsidiary more than just the alter ego of the defendant.[55] This was true even though the value of the subsidiary stock was directly related to the value of the Tide Water stock in that the two securities consistently sold at prices substantially different from their related values. Although *Blau v. Hodgkinson* relied on the *Smolowe* and *Park & Tilford* decisions, the court departed from the "the defendant did not own the stock before the transaction, he did own the stock after the transaction" rationale of these former cases. Instead, the court tested the transaction by asking whether the securities in question were economically similar and thus would not give the insider a trading advantage over the public. At first glance, it would appear that the decision in *Blau v. Mission Corp.* radically broadened the criteria set forth in *Hodgkinson.* There was a broadening; however, it took the form of merely changing the standard for measuring the equality of the securities in question. The fact that securities involved in an exchange are economic equivalents may have little to do with their value as measured by the consideration investors are willing to pay to acquire them. Since it is the price of the security that interests the speculator and perhaps not its underlying worth, the Tide Water stock and the subsidiary stock were different securities.

In *Roberts v. Eaton,* the second case arising in 1954, the defendant family owned about forty-six percent of the Old Towne Corporation. Wishing to dispose of their holdings in the corporation, the defendants decided that a reclassification of the Old Towne stock would best effectuate this end. After making full disclosure of the defendants' proposed sale and

[53] 212 F.2d 77 (2d Cir.), *cert. denied,* 347 U.S. 1016 (1954); 103 U. PA. L. REV. 115 (1954); 40 MINN. L. REV. 79 (1955).

[54] 212 F.2d 82 (2d Cir.), *cert. denied,* 348 U.S. 827 (1954); 68 HARV. L. REV. 552 (1955); 53 MICH. L. REV. 749 (1955); 40 VA. L. REV. 797 (1954).

[55] At the time of the second exchange, the defendant owned only sixty percent of its subsidiary. See Blau v. Mission Corp., 212 F.2d 77, 80 (2d Cir.), *cert. denied,* 347 U.S. 1016 (1954).

receiving stockholder approval of the reclassification plan, the corporation reclassified all outstanding stock.[56] In the exchange all shareholders received a share of common stock and a share of preferred stock for each share of common stock previously held. The exchange was held not within section 16(b). The court enumerated three factors that precluded liability. First, all shareholders participated in the exchange, not just the defendants. Second, the sale was made only after full disclosure and stockholder approval of the exchange. Third, after reclassification, the defendants' interests continued proportionally unchanged. The court carefully emphasized that the third factor alone would not have been sufficient to preclude liability. Thus, the Second Circuit again carefully broadened its interpretation of section 16(b) to bring about its stricter application. The *Hodgkinson* case required only that the securities exchanged be economically similar, and the *Mission Corp.* case further refined this rule. *Roberts*, however, emphasized that continuity of interest, a condition that equates the economic equivalency test to the factual situation, would be insufficient to relieve the defendant from liability. However, in the *Roberts* case this criterion was necessary because had the court based its opinion solely on the defendants' interests continuing unchanged, it would have opened the door for widespread abuse. In *Hodgkinson*, the defendant did not have control of the corporation. In *Roberts*, however, the Eaton family could have easily worked their will over the directors and the stockholders. Thus, the decision, although requiring more than *Hodgkinson*, did not make as radical a departure as could be imagined.

In 1965, there were two decided cases involving the issue of whether a purchase was made in an exchange of corporate securities.[57] The important decision, a case previously discussed with the conversion cases,[58]

[56] The reclassification was considered desirable to make the outstanding stock more marketable. The reclassification of the stock in question changed all outstanding shares of common stock of five dollars par value into the same number of common shares with a one dollar par value. In addition, the shareholders received shares of preferred stock in proportion to their holdings.

[57] The second case, Marquette Cement Mfg. Co. v. Andreas, 239 F. Supp. 962 (S.D.N.Y. 1965), adds little to the discussion. Briefly, the defendant, a Marquette insider, owned stock in the North American Cement Corporation. Pursuant to reorganization plans, North American sold its assets to Marquette and received in return 200,000 shares of Marquette stock. North American was dissolved and the shares received distributed to North American shareholders. The defendant sold the shares received within six months. Holding that the receipt of the stock constituted a purchase, the court reasoned that the defendant received something different after the exchange than he had held in the North American stock. The defendant's contention that the transaction came within the scope of *Roberts v. Eaton* was quickly rejected because all Marquette shareholders were not treated alike. Clearly, this decision is in line with any standard enunciated by any prior court. As such, it fails to indicate any trend in the Second Circuit or in reorganization transactions.

[58] See text accompanying note 32 *supra*.

was the Ninth Circuit decision in *Blau v. Max Factor & Co.*[59] In *Max Factor*, the court held that an exchange of stock was not a purchase within section 16(b) because the exchange did not interrupt the defendant's continuity of investment. That is, the stock held by the defendants after the exchange was, in most respects, a security similar to that held before the exchange. And even though the defendants had control of the corporation, the court felt this factor had little bearing on the disposition of the case. Under the *Park & Tilford* rationale or a liberal application of the *Hodgkinson* standard, the defendants in *Max Factor* probably would have been liable because they had complete control of the corporation. But, despite this element of control, the result in *Max Factor* may have been the same under the *Mission Corp.* rationale and perhaps even under the *Roberts* decision because of the existence of other factors, *i.e.*, the securities were economic equivalents which were readily transferable and the common stock was accepted by brokers for a market sale of the Class A stock.

The latest judicial expression of what constitutes a purchase in a securities exchange transaction is *Blau v. Lamb*,[60] the decision discussed previously with the conversion cases. In two separate transactions, a purchase was held to have been made when there was an exchange of the common stock of one corporation for the convertible preferred stock of another corporation,[61] while a purchase was held not to have been made in an exchange of stock between a parent corporation and its closely held subsidiary. In the second exchange, Lamb Enterprises, an Air-Way Industries insider and co-defendant in the suit, acquired from Lamb Industries shares of Air-Way stock in exchange for shares in Lamb Industries. Lamb Enterprises owned about eighty-eight percent of Lamb Industries.[62] The court

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59 342 F.2d 304 (9th Cir.), *cert. denied*, 382 U.S. 892 (1965).

60 Civil No. 29940, 2d Cir., June 27, 1966. This is the same case discussed in the text accompanying note 36 *supra*.

61 Blau v. Lamb, 242 F. Supp. 151 (S.D.N.Y. 1965). The defendants did not contest this holding on appeal. In this transaction Air-Way Industries offered to the stockholders of Lamb Industries one share of its newly created convertible preferred stock in exchange for five shares of Lamb Industries. The defendant, an Air-Way Industries' insider, exchanged his stock in Lamb Industries for the preferred stock and subsequently sold the shares received within six months. Relying on *Blau v. Hodgkinson*, the court said the defendant had a choice: retain his shares of Lamb Industries or exchange them in accordance with the offer. Having chosen the latter, the defendant received securities totally different than the securities he had given up. Blau v. Lamb, *supra* at 154-55.

62 Lamb Enterprises, the parent corporation, owned eighty-eight percent of Lamb Industries. Edward Lamb, a co-defendant, and members of his family owned about nine percent of Lamb Industries while the remaining three percent was owned by employees or former employees of Lamb Industries. See Blau v. Lamb, *supra* note 61. Lamb Enterprises was itself solely owned by Edward Lamb, members of his family and corporations controlled by them. Lamb Enterprises was, in effect, the personal holding company for the Lamb interests.

reasoned that the rule announced in the first part of the *Mission Corp.* decision, that is, that a transfer of stock to a wholly owned subsidiary does not constitute a sale within section 16(b),[63] was not applicable where the subsidiary was ninety-seven percent owned by both defendants and members of the Lamb family.[64] The court failed to give a standard by which future courts could determine the amount of control necessary to invoke this rule; however, it was felt that the unity of interest between the defendants Lamb and Lamb Enterprises, and Lamb Industries was not sufficiently affected by this transfer of securities to apply the sanctions of section 16(b). Although the decision in Lamb restricted the rule laid down in *Mission Corp.* by extending the exemption provided, the *Lamb* rule itself must be restricted to the situation where one party, in this case the defendant Lamb, has complete corporate control of the parent corporation and its subsidiary.[65] As such, the narrowing interpretation of section 16(b) provided by the *Lamb* decision does not radically change the *Mission Corp.* rule. In a like manner, the *Lamb* decision does not radically change *Mission Corp.'s* rationale. In both cases, the transactions were tested by the question of whether the exchange gave the insider a trading advantage because of inside information.

With the exception of the *Lamb* case, some later decisions appear to broaden the application of section 16(b) by setting forth a more objective rule. The *Mission Corp.* decision held that mere economic equivalence of the securities involved in an exchange will not defeat the sanctions of section 16(b). The *Roberts* decision then refined this rule. However, because of the *Lamb* decision, the rationale of these decisions, *i.e.*, that the existence of certain factors precludes or does not preclude liability under section 16(b), may no longer be valid—at least in the Second Circuit. Furthermore, the Ninth Circuit, in the *Max Factor* decision, applied a rationale that is similar to that in *Lamb*. Thus, it may well be that the more objective approach, with the exception of the decisions in *Heli-Coil, Petteys* and *Western Auto Supply Co.*, has become an insignificant factor in section 16(b) reasoning.

D. *Put and Call Options*

A "Call" is an option contract paid for by the buyer upon delivery of the contract, giving him the right, at his option, to buy from the maker or

63 The district court, in Blau v. Lamb, 242 F. Supp. 151 (S.D.N.Y. 1965), reasoned that it could not extend the exemption allowed in the exchange of securities between a parent corporation and its wholly owned subsidiary to the situation where the parent corporation owned only eighty-eight percent of the subsidiary.

64 See note 62 *supra*.

65 Furthermore, the parent corporation in *Mission Corp.* owned only sixty percent of its subsidiary, while in *Lamb* the parent owned nearly ninety percent of its subsidiary. See note 55 *supra*.

seller of such contract a certain number of shares of stock at a fixed price on or before a stipulated date.[66] A "Put" is an option contract paid for by the buyer upon delivery of the contract, giving him the right, at his option, to deliver to the maker or seller of the contract a certain number of shares of stock at a fixed price on or before a stipulated date.[67] These option contracts are often used as a medium for speculation. They are exercisable at the option of the holder who will generally exercise the option only if it is to his advantage to do so.[68] Although there is little resemblance between these option contracts and employee compensation warrants, the decision in *Silverman v. Landa*,[69] the only decided case dealing with puts and calls, was reasoned from the recent warrant case of *Blau v. Ogsbury*.[70]

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66 FILER, UNDERSTANDING PUT AND CALL OPTIONS 24-25 (1959).

67 *Id.* at 20-21.

68 *Id.* at 14-15.

69 306 F.2d 422 (2d Cir. 1962).

70 210 F.2d 426 (2d Cir. 1954). This case arose from an insider's acquisition of warrants issued by a corporation as part consideration under an employment contract. The employment contract was entered into in 1941. The insider agreed to exercise the warrants in 1945, and he paid the consideration for the warrants in 1948. The court was presented with the issue of *when* the defendant purchased the underlying securities, *i.e.*, the stock received upon the exercise of the option. It was reasoned that the purchase was made when the defendant incurred an irrevocable liability to purchase the stock in 1945, because that was when the rights and obligations of the defendant became fixed and the place in time that any trading advantage would begin.

The *Ogsbury* decision was preceded by three warrant cases that turned on the question of when the rights were purchased by the insider within the meaning of § 16(b). By way of dictum, the court in Truncale v. Blumberg, 80 F. Supp. 387 (S.D.N.Y. 1948) said that a purchase of the warrants was made at the time of their actual issuance to the defendant. In 1951, a California district court applied equitable principles in holding the defendant not liable when he concurrently exercised the options received under an employment contract and sold a portion of the stock received to raise the consideration needed to exercise the options. Consolidated Eng'r Corp. v. Nesbit, 102 F. Supp. 112 (S.D. Cal. 1951).

One year after *Truncale*, the Second Circuit held, in Shaw v. Dreyfus, 172 F.2d 140 (2d Cir.), *cert. denied*, 337 U.S. 907 (1949), that an acquisition of shareholder warrants by an insider did not constitute a purchase within § 16(b). The court analogized the issuance of the warrants to a stock dividend saying that when all shareholders are treated alike, the insider could not possibly use his position to the detriment of the other shareholders. This decision limited the earlier *Park & Tilford* decision because here, as in *Park & Tilford*, the defendant did not have to accept the warrants, but once he did, he became bound not to sell them, or the underlying securities if the warrants were exercised, within six months.

For an analysis of the inequities and inconsistencies in the judicial treatment of stock options, see Hardee, *Stock Options and the "Insider Trading" Provisions of the Securities Exchange Act*, 65 HARV. L. REV. 997 (1952).

The *Ogsbury* decision, and its "rights and obligations" doctrine, has also been adopted as the governing rationale in a case involving a contract to purchase securities. In Stella v. Graham-Paige Motors Corp., 132 F. Supp. 100 (S.D.N.Y. 1955), *remanded for further findings*, 232 F.2d 299 (2d Cir.), *cert. denied*, 352 U.S. 831 (1956), *on remand*, In *Silverman*, the defendant, a Fruehauf Trailer Company insider, issued two call options of 500 shares each and one put option of 500 shares. The options were to expire one year from the date of issue. The call options were never exercised and the put option was exercised more than six months after its issuance. In holding the simultaneous issuance of a put and call not to be a purchase and sale of the underlying securities, the court reasoned that, "By its nature, the option is one-sided; it fixes the obligation, but not the rights of the issuer. Landa (the defendant) cannot be said to have 'sold' or 'purchased' Fruehauf stock; should the options lapse unexercised . . . no change in his beneficial ownership of the underlying security would occur."[71] Thus, only if both the put and call options were exercised within six months would there have been a purchase and sale of the underlying stock. In the recent warrant case of *Blau v. Ogsbury*,[72] on which the court in *Silverman* heavily relied, the court said the insider purchased the securities when his rights and obligations were fixed. The *Silverman* court denied liability because the rights of the insider were not fixed; however, the optionor of a put and call contract has no rights under the contract that could possibly affect his trading advantage. Thus, denying liability on this ground appears to make a great departure from the *Smolowe* rationale and, perhaps more importantly, the warrant cases.[73] Conceptually, there was no purchase and sale of the underlying securities within six months. However, under the more objective approach of *Smolowe*, the statutory definition of purchase and sale would probably control, *i.e.*, a contract to buy and a contract to sell.[74] To date, the courts have not decided the applicability of section 16(b) when the insider acquires a put or call option. The issue may be resolved in *Miller v. General Outdoor Advertising Co.*[75] on remand from the Second Circuit.

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149 F. Supp. 390 (S.D.N.Y. 1957), *aff'd*, 259 F.2d 476 (2d Cir. 1958), *cert. denied*, 359 U.S. 914 (1959), the defendant, a Kaiser-Frazer insider, contracted to purchase Kaiser-Frazer stock. Because of insufficient funds, the contract provided that the defendant should use best efforts to borrow the money and if it was unable to obtain the loan, it could terminate the contract. The court held the purchase date to be that time when the defendant's rights and obligations were fixed, *i.e.*, when the parties had executed the contract. 232 F.2d at 301. This reasoning may be insignificant, however, because the court placed considerable weight on the fact that the defendant did not become an insider until he had executed the contract. *Ibid.* In 1964, the court in Booth v. Varian Associates, 334 F.2d 1 (1st Cir. 1964), *cert. denied*, 379 U.S. 961 (1965), modified the *Stella* decision. The *Booth* court held that the existence of a mutually binding contract may not necessarily constitute a purchase of the stock by the buyer if the facts show the purchaser to have no investment position in the securities until a time after the contract had been made.

71 Silverman v. Landa, 306 F.2d 422, 424 (2d Cir. 1962).

72 210 F.2d 426 (2d Cir. 1954).

73 See note 70 *supra*.

74 See text accompanying notes 24, 25 *supra*. *But see* text accompanying note 26 *supra*.

75 337 F.2d 944 (2d Cir. 1964). The plaintiffs to this suit are contending that

III. Conclusion

At one time, *Smolowe* and *Park & Tilford* were said to reflect the objective approach in the construction of section 16(b). The *Ferraiolo* decision, however, made a significant inroad into the rationale of these cases by reasoning that certain factors made it impossible for the insider to use inside information for an unfair trading advantage. Later, the decisions in *Max Factor* and *Roberts* redefined the rule purportedly set forth in *Ferraiolo.*

But, these inroads into the objective approach were not widely accepted. The decisions in *Heli-Coil* and *Western Auto Supply Co.* returned to the more objective approach by a rationale perhaps even more dogmatic than that laid down in *Smolowe.* In *Heli-Coil,* the court clearly indicated that any transaction that could, under any set of circumstances, be brought within the ambit of section 16(b) would be subject to its sanctions regardless of whether the transaction could have been used for unfair insider trading. In *Western Auto Supply Co.,* the court used a similar rationale in looking to the plain meaning of sale when the facts of the case made liability necessary even under the more subjective view. However, this recent return to the objective view was short-lived. The Second Circuit, in the *Lamb* case, redefined and clarified the *Ferraiolo* rule in a decision that represents a truly subjective approach. Section 16(b) expressly provides that profits are recoverable by the corporation irrespective of the intent of the insider —thus the reference to the objective measure of proof.[76] But the *Lamb* decision does not require an inquiry into the insider's intent. Instead, it requires an inquiry into the transaction to determine whether it could have been used for profit based on inside information. And if it is found that the transaction could have been so used, the inquiry ends and liability is imposed. On the other hand, if the transaction could not have been a vehicle for profit based on inside information, the sanctions are not imposed. The approach is still objective; the plaintiff need only show that the defendant, under any set of circumstances, could have used the transaction for the purposes the section sought to proscribe.

The *Lamb* decision has taken a step forward in clarifying the Second Circuit's interpretation of purchase and sale under section 16(b). As such, the *Lamb* rationale has discarded the rationale in *Roberts* and *Mission Corp.* which had looked primarily to the factors of insider control and economic equivalence as determinative of the cases. Perhaps more important, the *Lamb* decision may have discredited the rationale in the gift cases of *Truncale* and *Shaw* in which an element of subjective proof exists.

the put and call options are in themselves equity securities. If it is decided that they are not equity securities, the issue of purchase and sale may not be decided.

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

There can be no doubt that the rationale in *Lamb* is sound. In a like manner, the recent dogmatic decisions in *Heli-Coil* and *Western Auto Supply Co.* misconstrued the "crude rule of thumb" set forth by the draftsmen.[77] The section intended an objective *measure of proof* but this does not mean they intended a rigid rule of law. Proof is evidence that a set of facts exist or do not exist. A rule of law should answer to reason, not convenience or simplicity.

L. D. W., III

[77] *Ibid.*