1965

Corporations - Short-Swing Profits: Proposal to Treat Purchase Options as Equity Securities, Creating Two Separate Holding Periods for Section 16(b) Purposes

Minn. L. Rev. Editorial Board

Corporations—Short-Swing Profits: Proposal To Treat Purchase Options as Equity Securities, Creating Two Separate Holding Periods for Section 16(b) Purposes

B. T. Babbitt, Inc., instituted a suit against its president under Section 16(b) of the Securities Exchange Act of 1934[1] to recover profits realized by him from various stock transactions. The transactions were as follows: 1) On 12/16/57 defendant obtained an option to buy 10,000 shares of Babbitt common stock at $3.44375 per share. The option was not exercisable until 12/4/58, at which time the market price of the stock was $9.3125 per share. 2) On 4/30/58 defendant purchased 591.06 shares of Babbitt preferred stock at $40 per share. Each share was convertible into 8.2 shares of common, until 6/30/59. 3) On 11/5/58, when the market price of the common stock was $8.6875 per share, defendant converted the preferred stock into 4,846 shares of common. 4) On 3/6/59 defendant sold 4,600 shares of common at $8.625 per share. 5) On 3/13/59 defendant exercised the option referred to in transaction 1) above, purchasing 10,000 shares of common at $3.44375 per share. 6) On 5/6/59 defendant sold 5,749 shares of common at $9.7945 per share.

The district court matched the fifth transaction, the March 13, 1959 exercise of the option — measuring the cost at the option price — with the fourth transaction, the March 6, 1959 sale, to find a short-swing profit of $23,833.75. The third transaction, the November 5, 1958 conversion — measuring the cost as the market value of common on that date — was matched with the sixth transaction, the May 6, 1959 sale, giving a short-swing profit of $6,360.37. On appeal the Second Circuit rejected both these pairings, *holding* that the March 13th exercise of the option — but with the cost measured by the fair market value of the stock on the date the option was first exercisable (12/4/58) rather than the option price — should have been matched with the May 6th sale, giving a short-swing profit of only $2,771.02; and that no other transactions resulted in any short-swing profit to defendant.[2] *B. T. Babbitt, Inc. v. Lachner*, 332 F.2d 255 (2d Cir. 1964).

1. 48 Stat. 896, 15 U.S.C. § 78p(b) (1958).

2. Defendant also argued that SEC Rule X–16b–3, 17 C.F.R. § 240.16b–3 (1960), which exempted nontransferable employee options from section 16(b), immunized the transactions from any liability. Since Perlman v. Timberlake, 172 F. Supp. 246 (S.D.N.Y.), decided on March 26, 1959, had declared the rule

Section 16(b) of the Securities Exchange Act of 1934 is intended to curtail the unscrupulous use of inside information for individual profit by officers, directors, and large shareholders of corporations.[3] It provides for recovery by the corporation of all profits realized from any purchase and sale or any sale and purchase of a corporation's stock within a six-month period by an officer, director, or stockholder holding 10 percent or more of the corporation's stock.[4] Because of the inherent difficulty in proving an insider's motive or expectation, section 16(b) applies irrespective of the presence or absence of any speculative intent at the time of the purchase or sale.[5] Similarly, good faith conduct and lack of actual inside information are not valid defenses.[6]

All possible short-swing profits accruing to insiders are recoverable by the corporation under section 16(b).[7] The measure of profit recoverable is derived by matching the cost of stock purchased at the lowest price with that sold at the highest price during any six-month period.[8] A complex series of transactions makes application of this seemingly simple formula difficult. Furthermore, the *Babbitt* case requires consideration of what constitutes a purchase and a sale, at what price they are to be measured, and what is an "equity security" within section 16(b).

The conversion of the preferred shares into common constituted a purchase of the common at its market price on the November 5th conversion date within the accepted construction of

---

invalid as to purchases of common stock by exercise of the option, the court rejected the defense of good faith reliance on the rule for the May 6, 1959 sale. See Securities Exchange Act of 1934, § 23(a), as amended, 49 Stat. 1379 (1936), 15 U.S.C. § 78w(a) (1958).

3. See S. REP. No. 1455, 73d Cong., 2d Sess. 55 (1934). See also Adler v. Klawans, 267 F.2d 840, 844 (2d Cir. 1959); Kornfeld v. Eaton, 217 F. Supp. 671, 673 (S.D.N.Y. 1963), *aff'd*, 327 F.2d 263 (2d Cir. 1964); Yourd, *Trading in Securities by Directors, Officers, and Shareholders: Section 16 of the Securities Exchange Act*, 38 MICH. L. REV. 133, 134 (1939).

4. See, *e.g.*, Magida v. Continental Can Co., 12 F.R.D. 74, 78 (S.D.N.Y. 1951).

5. See Smolowe v. Delendo Corp., 136 F.2d 231, 235 (2d Cir.), *cert. denied*, 320 U.S. 751 (1943); Stella v. Graham-Paige Motors Corp., 132 F. Supp. 100, 102 (S.D.N.Y. 1955), *cause remanded*, 232 F.2d 299 (2d Cir. 1956), *cert. denied*, 352 U.S. 831 (1957); *Hearings Before the Senate Committee on Banking and Currency on S. Res. 84 and S. Res. 56 and S. Res. 97*, 73d Cong., 1st Sess., pt. 15, at 6557 (1934); Yourd, *supra* note 3, at 133–34.

6. See, *e.g.*, Park & Tilford, Inc. v. Schulte, 160 F.2d 984, 987 (2d Cir.), *cert. denied*, 332 U.S. 761 (1947); Smolowe v. Delendo Corp., 136 F.2d 231 (2d Cir.), *cert. denied*, 320 U.S. 751 (1943).

7. *Id.* at 239.

8. *Id.* at 238–39. See generally 2 LOSS, SECURITIES REGULATION 1062–66 (2d ed. 1961).

section 16(b).[9] The only sale of common within six months of this conversion — the fourth transaction — was at a lower price than the conversion "purchase" price.[10] Therefore, the instant court properly rejected the lower court's determination of a short-swing profit based on the conversion.[11] If the convertible preferred had been purchased within six months of the conversion, recovery of the difference between the cost of the preferred and the value of the common into which it was converted would seem appropriate. Since the conversion was a purchase of the common, it should also be considered a sale of the preferred within section 16(b).[12]

The March 13th exercise of the option was also a purchase of the common stock under prior decisions,[13] and this date is used for determining the six-month period. In establishing the cost of the common stock acquired, the instant court reversed the lower court, and followed *Steinberg v. Sharpe*[14] finding the purchase price to be the fair market value of the stock on the date on which the option was first exercisable.[15] Using this value rather than the option price permits the insider to retain the long-term increment in the value of the option, an increment representing com-

9. See Park & Tilford, Inc. v. Schulte, 160 F.2d 984 (2d Cir.), *cert. denied*, 332 U.S. 761 (1947). But as to forced conversions, see Ferraiolo v. Newman, 259 F.2d 342 (6th Cir. 1958), *cert. denied*, 359 U.S. 927 (1959).

10. Since both parties had stipulated that there was no market for the preferred on the date of conversion, 332 F.2d at 258, the court took the market value of the common received on the date of conversion as the purchase price. Had the preferred had an independent market value, the purchase price would have been measured by this value. See Park & Tilford, Inc. v. Schulte, *supra* note 9, at 989–90.

11. Even if a profit were realized by matching the November 5th conversion (or the March 13th exercise) with the March 6th sale, it would seem that defendant would be immune from liability under SEC Rule X–16b–3. See note 2 *supra*.

12. See Blau v. Lamb, 163 F. Supp. 528, 532–33 (S.D.N.Y. 1958); 2 Loss, *op. cit. supra* note 8, at 1067–68; Cook & Feldman, *Insider Trading Under the Securities Exchange Act*, 66 HARV. L. REV. 612, 624 (1953); *cf.* Heli-Coil Corp. v. Webster, 222 F. Supp. 831 (D.N.J. 1963). However, a forced conversion probably should not be treated as a sale of the preferred. See Ferraiolo v. Newman, 259 F.2d 342 (6th Cir. 1958), *cert. denied*, 359 U.S. 927 (1959).

13. See, *e.g.*, Greene v. Dietz, 247 F.2d 689 (2d Cir. 1957); Shaw v. Dreyfus, 172 F.2d 140, 142 (2d Cir.), *cert. denied*, 337 U.S. 907 (1949); Perlman v. Timberlake, 172 F. Supp. 246, 256 (S.D.N.Y. 1959); Steinberg v. Sharpe, 95 F. Supp. 32 (S.D.N.Y. 1950), *aff'd on opinion below*, 190 F.2d 82 (2d Cir. 1951).

14. *Ibid.*

15. When dealing with options, there are three dates to be kept in mind: (1) the date of acquisition of the option, (2) the date when the option is first exercisable, and (3) the date when the option is actually exercised.

pensation for service to the corporation.[16] If cost is measured by the value of the stock on the exercise date, the option holder could sell immediately after exercise with no recoverable profit, even though he may have used inside information to determine when to exercise.[17]

If the option is exercised more than six months after it first becomes exercisable, use of the *Steinberg* and *Babbitt* method to determine the purchase price in computing the amount of recovery seems improper. SEC Rule X–16b–6[18] alleviates the hardship imposed under *Steinberg* in the more extreme cases. It provides that the purchase price of stock may be measured at "the lowest market price of any security of the same class within 6 months before or after the date of sale" when the option is exercised more than six months after it was acquired.[19] The rule is at best an artificial solution; the cost it establishes is totally unrelated to any actual transaction of the defendant. By implication it accepts the extension of *Steinberg* under which the defendant is forced to disgorge profits earned over more than six months[20] — in contravention of the act itself.[21]

It appears possible to treat an employee option as an equity security[22] and thereby achieve results more consistent with the

16. See Steinberg v. Sharpe, 95 F. Supp. 32, 33 (S.D.N.Y. 1950); Meeker & Cooney, *The Problem of Definition in Determining Insider Liabilities Under Section 16(b)*, 45 VA. L. REV. 949, 968 (1959); 64 HARV. L. REV. 1378, 1380–81 (1951).

17. See Steinberg v. Sharpe, *supra* note 16, at 33–34.

18. 17 C.F.R. § 240.16b–6 (1954).

19. As indicated in the instant case, 332 F.2d at 259, this rule is expressly inapplicable if it leads to larger profits than would result in the absence of the rule.

20.

> We believe it inconsistent with . . . [the purpose of section 16(b)] . . . to include in the profits which the insider must surrender not only any profits attributable to the short-swing, but profits which represent the long term increment in value attributable to the possession of a right to acquire stock.

S.E.C. Securities Act Release No. 4509, at 3–6 (1950). The *Steinberg* case was pending when the rule was promulgated.

21. The rule has been upheld in Kornfeld v. Eaton, 217 F. Supp. 671 (S.D.N.Y. 1963), *aff'd*, 327 F.2d 263 (2d Cir. 1964); Blau v. Hodgkinson, 100 F. Supp. 361 (S.D.N.Y. 1951). It has, however, been criticized as being outside the Commissioner's authority to promulgate. See Hardee, *Stock Options and the "Insider Trading" Provisions of the Securities Exchange Act*, 65 HARV. L. REV. 997, 1006 (1952); Note, 69 YALE L.J. 868, 881 (1960).

22. A contrary position has been taken but with little or no analysis in 2 Loss, *op. cit. supra* note 8, at 1080–81; Cook & Feldman, *supra* note 12, at 624; Rubin & Feldman, *Statutory Inhibitions Upon Unfair Use of Corporate Information by Insiders*, 95 U. PA. L. REV. 468, 491–92 (1947).

policy of the act.[23] An option should qualify literally as a "warrant or right" to purchase a security; which is one portion of the definition of an "equity security" in section 3(a)(11).[24] In addition, the option holder may use inside information in determining when to exercise just as profitably as he can use such information in determining when to buy or sell the corporation's stock. Although the exercise of the option has no immediate effect on the stockholding public, the use of inside information to determine when to exercise enables the holder to maximize his personal advantage vis-a-vis the corporation. Such action seems contrary to the purposes of the act.[25]

If the option is treated as an equity security with the date first exercisable viewed as the purchase date and the date exercised as the date of sale, two separate holding periods arise for section 16(b) purposes. One is the period in which the exercisable option is held, the other is the period in which the stock acquired through exercise is held.[26] Convertible securities presumably would be so

23. See Hardee, *supra* note 21, at 1007–08. *But see* Cook & Feldman, *supra* note 12, at 622–24; Meeker & Cooney, *supra* note 16, at 968.

24. 48 Stat. 882, 15 U.S.C. § 78c(11) (1958). See Cook & Feldman, *supra* note 12, at 392; Note, 59 YALE L.J. 510, 514 n.18 (1950); *cf.* Note, 69 YALE L.J. 868, 873 (1960) (arguing that "puts" and "calls" were equity securities). *But cf.* Miller v. General Outdoor Advertising Co., 223 F. Supp. 790 (S.D.N.Y. 1963), which held that warrants and rights must be negotiable, and must be issued by the corporation; these are characteristics which a "call" does not have. The negotiability requirement seems too narrow an interpretation of the act. Moreover, an employee option is issued by the corporation and thus is distinguishable from puts and calls. Further, options seem to be certificates "of interest or participation in . . . a 'security'" and thus are "securities" within the act. Section 3(a)(10), 48 Stat. 882 (1934), 15 U.S.C. § 78c(10) (1958). Such a security is also an "equity security" if it is "convertible, with or without consideration, into . . . [stock]." Section 3(a)(11), 48 Stat. 882 (1934), 15 U.S.C. § 78c(11) (1958).

At present Rule X–16b–3 exempts from section 16(b) liability a director's or officer's acquisition of a qualified or restricted stock opinion. Before 1960, the rule also applied to the *stock* acquired pursuant to the options, but this provision was criticized in Greene v. Dietz, 247 F.2d 689 (2d Cir. 1957), and held invalid in Perlman v. Timberlake, 172 F. Supp. 246 (S.D.N.Y. 1959), and has since been deleted. The conclusion in *Greene* and *Perlman*, that the rule exceeded the SEC's authority, also should be applied to the option itself and the present rule held invalid.

25. The *Babbitt* and *Steinberg* cases attempt to prevent the use of inside information in connection with exercising an option by basing the cost of purchase of the common on the date when the option first became exercisable. See note 23 *supra* and accompanying text. See also Greene v. Dietz, *supra* note 24, at 693.

26. *Cf.* Note, 69 YALE L.J. 868, 876–90 (1960), suggesting a similar proposal for put and call transactions. Even if not persuasive as to puts and

treated under the act.[27] The similarities between options and convertible securities would seem to justify identical treatment.[28] The use of two separate short-swing periods maximizes recoverable profits while remaining within the six-months limitation of the act. If, as in *Babbitt*, the option becomes exercisable, is exercised, and the common received is sold within a six-month period, profits recovered are the same under either standard. When the period between the date the option is first exercisable and the date of exercise exceeds six months and the underlying securities are then sold within six months of the exercise, the proposed standard would limit recovery to the increase in the value of the securities between exercise and sale. But if the option is exercised within six months from the time it first becomes exercisable and the stock is held for more than six months before sale, recovery of the increase in value of the option from the exercisable to the exercise date would be permitted under the proposed standard.

Constitutional Law: Right To Travel Abroad Protected by First and Fifth Amendments

Appellants, top-ranking leaders of the Communist Party of the United States,[1] had their passports revoked pursuant to Section 6 of the Subversive Activities Control Act of 1950.[2] Section 6 made it a felony for members of communist organizations,

calls, the proposal should be applicable to the option transactions. See note 24 *supra*.

27. See notes 9 & 12 *supra* and accompanying text.

28. The value of the underlying common stock may determine the value of either options or convertible securities. Exercise or conversion may be accomplished at the holder's discretion. See Heli-Coil Corp. v. Webster, 222 F. Supp. 831 (D.N.J. 1963), in which a corporate director who converted debentures into common stock and later sold the stock was held liable for profits both on the purchase and sale of the stock and on the receipt and conversion of the debentures. *Cf.* Rubin & Feldman, *supra* note 22, at 492. See also Meeker & Cooney, *supra* note 16, at 965. The fact that the option may be nontransferable is not sufficient reason to distinguish the two. See note 24 *supra*.

1. Appellant Aptheker is editor of *Political Affairs*, the theoretical organ of the party in this country and appellant Flynn is chairman of the party. Aptheker v. Secretary of State, 378 U.S. 500, 515 (1964).

2. Section 6 reads:

> (a) When a Communist organization as defined in paragraph (5) of section 3 [*infra* note 14] of this title is registered, or there is in effect a final order of the Board requiring such organization to register, it shall be unlawful for any member of such organization, with knowledge