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INSIDER SECURITIES DEALINGS DURING CORPORATE CRISES

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THE problem of assuring the fidelity of corporate insiders[1] to the public investors in their enterprises figured prominently in legal literature and law reform proposals twenty-five or thirty years ago. In recent years, that question has attracted relatively less attention—in part because of the appearance or recognition of more significant problems in the relationship of publicly-held corporate enterprise to the national well-being, but in part also because of the development by courts, legislatures and administrative agencies—and to some extent by the insiders' community itself—of more exacting standards of loyalty. Recognition of broader obligations to their corporations[2] and to public investors[3] has meant redefinition of "improper" or "wrongful" conduct to include many kinds of behavior theretofore thought permissible,

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1 The scope of the term "insiders" varies somewhat with the context in which it is used. Unless otherwise indicated, the term when used hereinafter denotes officers, directors, and persons owning a sufficient quantity of a corporation's securities, or otherwise, to be deemed fairly to be able to command inside knowledge of and to exercise effective influence in its affairs.

2 See, *e.g.*, Israels, *The Implications and Limitations of the "Deep Rock" Doctrine*, 42 COLUM. L. REV. 376 (1942); *Symposium on Conflicts of Interest*, 17 BUS. LAW. 42 (1961).

3 *E.g.*, the expansion, both at common law and by reason of rule X-10B-5 (now rule 10b-5) promulgated by the Securities and Exchange Commission under the Securities Exchange Act of 1934, of the requirement that insiders disclose relevant facts affecting the value of the corporation's securities to those with whom they deal in such securities. See Cady, Roberts & Co., CCH FED. SEC. L. REP. ¶ 76803 (1961); Daum & Phillips, *The Implications of Cady Roberts*, 17 BUS. LAW. 939 (1962). Developments in this area are discussed in BALLANTINE, CORPORATIONS § 80 (2d ed. 1946); 3 LOSS, SECURITIES REGULATION 1446-74 (2d ed. 1961); STEVENS, CORPORATIONS 690-705 (2d ed. 1949); Conant, *Duties of Disclosure of Corporate Insiders Who Purchase Shares*, 46 CORNELL L.Q. 53 (1960); Note, *SEC Action Against Fraudulent Purchases of Securities*, 59 HARV. L. REV. 769 (1946); Note, *Civil Liability Under Rule X-10B-5*, 42 VA. L. REV. 537 (1956); Comment, *The Prospects for Rule X-10B-5; An Emerging Remedy for Defrauded Stockholders*, 59 YALE L.J. 1120 (1950). See Annots., 132 A.L.R. 260 (1940); 84 A.L.R. 615 (1933).

if not entirely proper. And it also has impelled the use of prophylactic rules to enforce those enlarged definitions; so that even though certain types of activity may not be wrongful or cause injury on every occasion when indulged in, they are nevertheless proscribed broadly, both for administrative reasons and in deference to the recurrent, if not uniformly held, notion that a corporate insider must be not only virtuous but above suspicion.

Insider dealings in securities of their corporations have been deemed a particularly appropriate area for such rigorous rules. Since 1934, Congress has made insiders accountable, without fault or proof of harm to anyone, for profits from "trading" in stock of corporations whose stock is listed on a securities exchange[4] and in all securities of public utility holding companies and their subsidiaries and of registered closed-end investment companies.[5] In Chapter X of the Bankruptcy Act, Congress struck, with additional sanctions covering a limited group of insiders,[6] not merely at "trading," but at any purchases or sales of any kind of security or claim during an insolvency reorganization. And, in reorganizations under the Holding Company Act, the Securities and Ex-

4 Section 16(b) of the Securities Exchange Act of 1934, 48 Stat. 896, 15 U.S.C. § 78p(b) (1958). "Trading" is defined for purposes of this and related legislation as purchases and sales or sales and purchases within any period of less than six months. "Insider" means director, officer or beneficial owner of more than 10% of any class of stock registered on a national securities exchange.

5 Section 17(b) of the Public Utility Holding Company Act of 1935, 49 Stat. 830, 15 U.S.C. § 79q(b) (1958). "Insiders" consist only of officers and directors, since controlling stockholders are, by definition, holding companies, subject to regulation. Section 30(f) of the Investment Company Act of 1940, 54 Stat. 836, 15 U.S.C. § 80a-29(f) (1958). "Insiders" include officers, directors, beneficial owners of more than 10% of any security (other than short-term paper), members of an advisory board, investment advisers, and affiliates of investment advisers.

6 Sections 212, 249 of the Bankruptcy Act, 52 Stat. 895, 901 (1938), 11 U.S.C. §§ 612, 649 (1958). Section 212 authorizes the reorganization court to "limit any claim or stock acquired by . . . [any agent, attorney, indenture trustee or committee] . . . in contemplation or in the course of the proceeding under this chapter to the actual consideration paid therefor." Section 249 provides in relevant part that "no compensation or reimbursement shall be allowed to any committee or attorney, or other person acting in the proceedings in a representative or fiduciary capacity, who at any time after assuming to act in such capacity has purchased or sold . . . claims [against] or stock" of the debtor. Corporate officers and employees of the debtor in possession have been held to be outside the scope of § 249, if not also of § 212. *In re* Nazareth Fairgrounds & Farmers' Mkt., Inc., 296 F.2d 678 (2d Cir. 1961), *cert. granted sub nom.* Wolf v. Weinstein, 369 U.S. 837 (1962). For comprehensive discussions of the operation of these provisions, see Bandler, *Securities Trading and Fee Sharing Under Chapter X of the Bankruptcy Act*, 15 RECORD OF N.Y.C.B.A. 230 (1960); Ferber, Blasberg & Katz, *Conflicts of Interest in Reorganization Proceedings Under the Public Utility Holding Company Act and Chapter X of the Bankruptcy Act*, 28 GEO. WASH. L. REV. 319 (1959); Note, 45 VA. L. REV. 1065 (1959).

change Commission, albeit with some backing and filling, appears to have adopted a comparable position in its rules and rulings.[7] However varied may be the sanctions enforcing it, the basic effort in all such instances is to discourage all insider securities dealings, even if innocent, in the specified contexts. Sanctions are imposed whether or not the insider was in fact influenced in conducting corporate affairs by the possibility of obtaining trading profits for himself, and whether or not the corporation or its security holders were in fact injured by his administration of its affairs or misled or overreached by his dealings in its securities.

The unusual breadth of the restrictions thus imposed, which have recently been receiving narrowing judicial interpretation,[8] and the apparent anomaly of making the insider accountable to the corporation rather than to the persons with whom he deals do not, at least a priori, invite extension of those restrictions to insider securities dealing in other contexts. On the other hand, inquiry into the propriety of such extension is suggested by the increasing incidence of various kinds of corporate readjustments which, in relevant respects, present the same problems as insolvency reorganization, *e.g.*, corporations selling their assets and seeking reinvestment opportunities, mergers, voluntary recapitalizations and liquidations. Similar considerations are evoked by the growth of the "over-the-counter" markets,[9] on which insiders

7 See Ferber, Blasberg & Katz, *supra* note 6, at 364-68. *Compare* United Corp., 37 S.E.C. 187, 194-95 (1956), *enforcement rev'd on other grounds*, 249 F.2d 168 (3d Cir. 1957), *and* Electric Power & Light Corp., 33 S.E.C. 348, 355-59 (1952), *enforcement rev'd on other grounds*, 210 F.2d 585 (2d Cir. 1954), *rev'd on other grounds*, 348 U.S. 341, *amended*, 349 U.S. 910 (1955), *with* International Hydroelectric Sys., 37 S.E.C. 297, 304-05 (1956); Long Island Lighting Co., 34 S.E.C. 600, 618-20, *aff'd on that point* (E.D.N.Y. 1953); Eastern Gas & Fuel Associates, 35 S.E.C. 150, 157-58, *enforcement denied in part*, 120 F. Supp. 460 (D. Mass. 1953), *enforcement ordered*, 218 F.2d 308 (1st Cir. 1954), *cert. denied*, 349 U.S. 949 (1955). *Compare* also *In re* Federal Water & Gas Corp., 28 S.E.C. 174 (1948), *enforced*, 87 F. Supp. 289 (D. Del. 1949), *direct cert. denied*, 340 U.S. 831 (1951), *aff'd*, 188 F.2d 100 (3d Cir. 1951), *cert. denied*, 341 U.S. 943 (1952), *and* Federal Water Serv. Corp. (Chenery litigation), 8 S.E.C. 893, 915-21 (1941), *rev'd*, 128 F.2d 303 (D.C. Cir. 1942), *reversal aff'd and case remanded to SEC*, 318 U.S. 80 (1943), *decision on remand*, 18 S.E.C. 231 (1945), *rev'd*, 154 F.2d 6 (D.C. Cir. 1946), *SEC order reinstated*, 332 U.S. 194 (1947), *and* Derby Gas & Elec. Corp., 9 S.E.C. 686, 707-08 (1941), *with* Standard Gas & Elec. Co., 34 S.E.C. 80, 114-15 (1952), Middle W. Corp., 27 S.E.C. 195 (1947), *enforced*, 76 F. Supp. 63 (D. Del. 1948), American States Util. Corp., 26 S.E.C. 718 (1947), *and* Cities Serv. Co., 26 S.E.C. 678 (1947).

8 See, *e.g.*, Blau v. Lehman, 368 U.S. 403 (1962); *In re* Nazareth Fairgrounds & Farmers' Mkt., Inc., 296 F.2d 678 (2d Cir. 1961), *cert. granted sub nom.* Wolf v. Weinstein, 369 U.S. 837 (1962).

9 For a discussion of the development of the over-the-counter markets, and citation to the repeated efforts to obtain legislation to extend many of the regulatory features

can trade free of the restrictions of section 16(b) of the Exchange Act.

I. DOCTRINAL ORIGINS AND DEVELOPMENT OF THE RULE OF INSIDER ACCOUNTABILITY WITHOUT FAULT

The historical development of accountability for profits from such insider dealings even when no fault or injury is shown reflects the various interests sought to be protected and the kinds of behavior sought to be discouraged. Long before the New Deal legislation, courts had evolved from the law of trusts the notion that a corporate officer or director could not enforce at face value claims against his corporation which he had purchased at a discount while it was insolvent and on the verge of, or in, bankruptcy or liquidation.[10] The resulting restriction to recovery only of the insider's cost, and occasionally of interest and expenses, was later applied to debt securities[11] as well as to trade or commercial claims and judgments[12] acquired during various forms of insolvency liquidation or reorganization. The limitations so im-

of the Securities Exchange Act, including § 16(b), to the larger corporations whose stocks are traded on over-the-counter markets but not on registered exchanges, see 2 LOSS, SECURITIES REGULATION 1149-52, 1277-87 (2d ed. 1961). See also Berman, *Regulation of Unlisted Securities,* Financial Analysts J., July-Aug. 1961, p. 45. The current investigation by the Securities & Exchange Commission of securities markets is also examining the question of extending the scope of regulation of the over-the-counter markets.

10 *E.g.,* Mothershead v. Douglas, 215 Ark. 519, 221 S.W.2d 424 (1949); Holland v. Heyman & Bro., 60 Ga. 174 (1878); Bramblet v. Commonwealth Land & Lumber Co., 26 Ky. L. Rep. 1176, 1179-80, 83 S.W. 599, 602 (Ct. App. 1904), *modified,* 27 Ky. L. Rep. 156, 84 S.W. 545 (Ct. App. 1905). See also Chouteau Ins. Co. v. Floyd, 74 Mo. 286, 291 (1881); Buckley v. Whitcomb, 121 N.Y. 107, 111-12, 24 N.E. 13, 14 (1890). In some cases, although the courts rely on the broad principle referred to in the text, the facts might well justify the same result on the narrower ground that the insider's behavior was otherwise demonstrably wrongful, *e.g.,* Jackson v. Ludeling, 88 U.S. 616 (1874); Canton Roll & Mach. Co. v. Rolling Mill Co., 168 Fed. 465 (4th Cir. 1909); Bonney v. Tilley, 109 Cal. 346, 42 Pac. 439 (1895); Lingle v. National Ins. Co., 45 Mo. 109 (1869); *cf.* Billings v. Shaw, 209 N.Y. 265, 103 N.E. 142 (1913).

11 *In re* Van Sweringen Co., 119 F.2d 231, 234 (6th Cir. 1941), *cert. denied,* 314 U.S. 671 (1942) (§ 77B); *In re* Philadelphia & W. Ry., 64 F. Supp. 738 (E.D. Pa. 1946) (§ 77B); *In re* Los Angeles Lumber Prod. Co., 46 F. Supp. 77 (S.D. Cal. 1941) (§ 77B); *cf. In re* Inland Gas Corp., 187 F.2d 813, 818 (6th Cir. 1951). *But cf. In re* New York Rys., 82 F.2d 739 (2d Cir.), *cert. denied,* 298 U.S. 687 (1936); *In re* Celotex Co., 12 F. Supp. 1, 5 (D. Del. 1935).

12 *In re* Bridgford Co., 237 F.2d 182 (9th Cir. 1956), *cert. denied,* 352 U.S. 1005 (1957) (ch. XI and bankruptcy); Monroe v. Scofield, 135 F.2d 725 (10th Cir. 1943) (bankruptcy); *In re* Norcor Mfg. Co., 109 F.2d 407 (7th Cir. 1940), *cert. denied,* 310 U.S. 625 (1940) (state receivership and § 77B); *In re* Jersey Materials Co., 50 F. Supp. 428 (D.N.J. 1943) (bankruptcy); *In re* McCrory Stores, 12 F. Supp. 267 (S.D.N.Y. 1935).

posed[13] contrast with the insider's relatively undisputed freedom otherwise to enforce claims purchased at a discount[14] when he has no special duty to purchase them for the corporation.[15] This difference has been rested on the premise that bankruptcy (or insolvency culminating in liquidation) works a material change in the insider's functions and duties which makes him equivalent to a trustee for claimants against, or agent for, the corporation.[16]

13 More severe sanctions against such dealing, such as denial of compensation or subordination of claims were imposed upon other fiduciaries such as protective committees and their attorneys. *E.g.*, Marquette Manor Bldg. Corp., 97 F.2d 733 (7th Cir.), *cert. denied*, 305 U.S. 648 (1938); *In re* Republic Gas Corp., 35 F. Supp. 300, 303 (S.D.N.Y. 1936), *aff'd*, 118 F.2d 405 (3d Cir. 1941); *In re* Paramount-Publix Corp., 12 F. Supp. 823, 828 (S.D.N.Y. 1935), *rev'd on other grounds*, 83 F.2d 406 (2d Cir. 1936); *cf.* Missouri Pac. R.R., 217 I.C.C. 671, 675 (1937) (reorganization).

14 From time to time, on the analogy to express trustees, language, and occasionally rulings, appear in the cases suggesting a categorical prohibition against insider enforcement at face value of any claims acquired at a discount, even though acquired when the corporation is solvent and able to pay. See Davis v. Rock Creek L.F. & M. Co., 55 Cal. 359, 364 (1880); Telegraph v. Lee, 125 Iowa 17, 98 N.W. 364 (1904); McDonald v. Haughton, 70 N.C. 393, 399 (1874); Weissman v. A. Weissman, Inc., 374 Pa. 470, 97 A.2d 870 (1953); Hill v. Frazier, 22 Pa. 320 (1853). See also Allen-Foster-Willett Co. v. Willett, 227 Mass. 551, 556, 116 N.E. 875, 876 (1917); Duncomb v. New York H. & N.R. Co., 84 N.Y. 190, 202 (1881). See generally Lake, *The Use for Personal Profit of Knowledge Gained While a Director*, 9 MISS. L.J. 427, 439-43 (1937). However, under the predominant case law, in apparent recognition of the economic and social differences generally obtaining between claims against express trusts and corporate obligations or debt securities [see, *e.g.*, Inglehardt v. Thousand Island Hotel Co., 32 Hun 377, 383 (Sup. Ct. 1884), *rev'd*, 109 N.Y. 454 (1888)] the insider is free to enforce at par matured claims (and, a fortiori, unmatured claims) purchased at a discount while the corporation is solvent, unless in doing so he has violated some special duty to the corporation. *E.g.*, Alexandrine Hotel Co. v. Whaling, 313 Mich. 15, 20 N.W.2d 793 (1945); Punch v. Hipolite Co., 340 Mo. 53, 100 S.W.2d 878 (1936); Seymour v. Spring Forest Cemetery Ass'n, 144 N.Y. 333, 342-45, 39 N.E. 365, 366-67 (1895), and cases collected in Annot., 13 A.L.R.2d 1172 (1950). See Comment, 1960 DUKE L.J. 613.

15 Special obligations to the corporation are violated by purchases for the insider's own account when he is instructed to purchase for the corporation [Commonwealth Fin. Co. v. McHarg, 282 Fed. 560 (2d Cir. 1922); Kroegher v. Calivada Colonization Co., 119 Fed. 641 (3d Cir. 1902); Kimmel v. Greeting, 2 Grant 125 (Pa. 1853)]; purchases in direct competition with a corporate program, as when a special sinking fund has been set up [*In re* Philadelphia & W. Ry., 64 F. Supp. 738, 739-40 (E.D. Pa. 1946); Brophy v. Cities Serv. Co., 31 Del. Ch. 241, 70 A.2d 5 (1949); Seymour v. Spring Forest Cemetery Ass'n, *supra* note 14]; or purchases when the corporation is financially able to make the purchase (having either the cash or the credit to do so), and presumably, in the exercise of sound business judgment, should do so. Wabunga Land Co. v. Schwanbeck, 245 Mich. 505, 222 N.W. 707 (1929); Young v. Columbia Land & Inv. Co., 53 Ore. 438, 99 Pac. 936 (1909), *rehearing denied*, 53 Ore. 445, 101 Pac. 212 (1909); see Ripperburger v. Allyn, 25 F. Supp. 554, 555 (S.D.N.Y. 1938); Higgins v. Lansingh, 154 Ill. 301, 385-87, 40 N.E. 362, 387-88 (1895); *cf.* Glen Allen Mining Co. v. Park Galena Mining Co., 77 Utah 362, 380, 296 Pac. 231, 238 (1931).

16 See, *e.g.*, *In re* Philadelphia & W. Ry., 64 F. Supp. 738, 740 (E.D. Pa. 1946); *In re* Los Angeles Lumber Prod. Co., 46 F. Supp. 77, 87 (S.D. Cal. 1941); Higgins v. Lansingh, *supra* note 15; Seymour v. Spring Forest Cemetery Ass'n, 144 N.Y. 333, 39 N.E. 365

The governing notion, particularly in the earlier cases, is that when insolvency liquidation or reorganization is imminent, it becomes the duty of corporate officers and directors to attempt to settle or discharge the matured or maturing claims against the corporation on the most favorable terms, in order to preserve assets for, or produce the largest possible distribution of assets or new participations to, the remaining claimants. To purchase, or attempt to purchase, at a discount, claims which the corporation is thus obliged to settle puts the insider in a position of potential—if not actual—conflict with the best interests of the remaining claimants, who have become his beneficiaries. A corporate insider, like an express trustee,[17] is to be discouraged from taking such a position[18] even if the corporation itself is not able to purchase or otherwise settle the claims[19] or if the insider's purchase will actually benefit the corporation materially.[20] This requirement of accountability for profits regardless of whether the insider's purchase has injured anyone or indeed even if it has inured to the benefit of other creditors is, of course, designed to avert the temptation to do wrong and the appearance of wrongdoing as well as to prevent actual misconduct.

But the misconduct against which the rule is directed is not only that against which an express trustee is traditionally enjoined, *i.e.*, competition with the corporation for the purchase of claims at a discount.[21] As the later cases indicate, the rule is designed

(1895); *cf. In re* Calton Crescent, Inc., 80 F. Supp. 822, 824 (S.D.N.Y. 1948), *aff'd*, 173 F.2d 944 (2d Cir.), *aff'd*, 338 U.S. 304 (1949).

17 BOGERT, TRUSTS AND TRUSTEES § 543(d) (2d ed. 1960); RESTATEMENT (SECOND), AGENCY § 388 (1958); RESTATEMENT, RESTITUTION §§ 190-200 (1937); RESTATEMENT, TRUSTS § 170, comments *j* and *k* at 368-69, § 203, § 206, comments *h* and *i*, at 466 (1959); 2 SCOTT, TRUSTS §§ 170.21, 203 (2d ed. 1956); Scott, *The Trustee's Duty of Loyalty*, 49 HARV. L. REV. 521, 524-25 (1936).

18 See, *e.g.*, *In re* Republic Gas Corp., 35 F. Supp. 300 (D. Del. 1936), *aff'd*, 118 F.2d 405 (3d Cir. 1941); *In re* Paramount Publix Corp., 12 F. Supp. 823 (S.D.N.Y. 1935), *rev'd on other grounds*, 83 F.2d 406 (2d Cir. 1936); Lingle v. National Ins. Co., 45 Mo. 109 (1869). *But cf.* RESTATEMENT, RESTITUTION § 196, comment *b* (1937).

19 *In re* Los Angeles Lumber Prod. Co., 46 F. Supp. 77 (S.D. Cal. 1941); *cf.* Berner v. Equitable Office Bldg. Corp., 175 F.2d 218, 221 (2d Cir. 1949); Regal v. Gulliver, [1942] 1 All E.R. 378 (H.L.).

20 *In re* McCrory Stores, 12 F. Supp. 267 (S.D.N.Y. 1935); *cf.* Bramblet v. Commonwealth Land & Lumber Co., 26 Ky. L. Rep. 1176, 83 S.W. 599 (Ct. App. 1904), *modified*, 27 Ky. L. Rep. 156, 84 S.W. 545 (Ct. App. 1905).

21 Although it is acquisition of the claim against the corporation, whether or not at a discount, during insolvency, that places the insider in a position of conflict (see BOGERT, *op. cit. supra* note 17), the case law tends to emphasize the acquisition at a discount, in apparent recognition of the evil as the temptation to compete with the

also to discourage misconduct by the insider to the liquidation or reorganization process for the purpose of facilitating his advantageous purchases to the possible detriment of the insolvent and its other claimants. Denial of profit to insiders "is not imposed upon the theory that such profits belong to the corporation by reason of any property right that it may have in them but is an administrative sanction for the enforcement of the rules of fiduciary conduct set by law."[22] On the other hand, the cases often suggest that the rule developed by the courts was no more designed than was the law of trusts to benefit those creditors who sold their claims to the insiders.[23] Its roots in the law of express trusts produced the incongruous result that creditors who sold their claims were apparently regarded as "claimants" to whom little or no fiduciary duty was owed by the insider, while creditors who retained their claims became the *cestuis* for whose benefit he was required to act.[24]

corporation for an advantageous purchase of the claim. *Compare* Weissman v. A. Weissman, Inc., 374 Pa. 470, 70 A.2d 870 (1953), *with* Warren v. Wheatley, 231 Ark. 707, 331 S.W.2d 843 (1960), *and* Weissman v. A. Weissman, Inc., 382 Pa. 189, 114 A.2d 797 (1955). Compare note 15 *supra.*

22 *In re* Philadelphia & W. Ry., 64 F. Supp. 738, 741 (E.D. Pa. 1946). See also Berner v. Equitable Office Bldg. Corp., 174 F.2d 218, 222 (2d Cir. 1949); *cf.* McDonald v. Haughton, 70 N.C. 393 (1874). Nevertheless it may be noted that apart from the rule of insider behavior it is designed to enforce—which could be achieved by a number of other sanctions—the notion that the insiders should account to the corporation for their profits also reflects the underlying premise that those profits are in some way attributable to his use of inside knowledge or power which he holds in a representative capacity, and therefore should be shared with those he represents. See, *e.g.,* Dunnett v. Arn, 71 F.2d 912 (10th Cir. 1934); Weissman v. A. Weissman, Inc., *supra* note 21; BOGERT, *op. cit. supra* note 17; *Hearings on H.R. 4344, 5065 and 5832 Before House Committee on Interstate and Foreign Commerce,* 77th Cong., 1st Sess. 1257 (1942). To the extent that accountability is enforced prophylactically, *i.e.,* whether or not inside information was actually used, the notion that the insider has made use of a collective asset is not entirely adequate to justify the result.

23 See *In re* Van Sweringen, 119 F.2d 231 (6th Cir. 1941), *cert. denied,* 314 U.S. 671 (1942); *In re* Norcor Mfg. Co., 109 F.2d 407 (7th Cir. 1940), *cert. denied,* 310 U.S. 625 (1941); and *In re* Los Angeles Lumber Prod. Co., 46 F. Supp. 738 (E.D. Pa. 1946); in all of which there were indications that the sellers had been overreached by the insiders. See also Powell v. Willamette Valley R.R., 15 Ore. 393 (1887); *but cf. In re* Republic Gas Corp., 35 F. Supp. 300, 303 (D. Del. 1936), *aff'd,* 118 F.2d 405 (3d Cir. 1941); Boyum v. Jordon, 146 Minn. 66-79, 178 N.W. 158, 163-64 (1920); McDonald v. Haughton, *supra* note 22.

24 See note 23 *supra.* The same incongruity is apparent in the denial to assignees in bankruptcy of the right to enforce claims purchased by them at a discount. See, *e.g., Ex parte* Lacey, 6 Ves. Jr. 625 (Ch. 1802); *Ex parte* James, 8 Ves. Jr. 337 (Ch. 1803); United States Fid. & Guar. Co. v. Eichel, 219 Fed. 803 (3d Cir. 1915); Manhattan Cloak & Suit Co. v. Dodge, 120 Ind. 1, 21 N.E. 344 (1889); In the Matter of Dwight, 61 App. Div. 357, 70 N.Y. Supp. 563 (1901), *appeal dismissed,* 173 N.Y. 583 (1902); *cf.* Mosser v. Darrow, 341 U.S. 267 (1951); Jackson v. Smith, 254 U.S. 586 (1921).

The principle thus adapted by the courts from the law of trusts is one of the sources for the broadside challenge to insider transactions embodied in chapter X,[25] and in the Securities and Exchange Commission's administration of the Holding Company Act. But both the reorganization and the anti-trading legislation import additional considerations in striking at insider dealings in securities. In the evolution from a stricture designed to protect relatively well-informed trade or loan creditors of closed corporations to one designed to protect widely scattered public investors, the scope of the attack was expanded. Sanctions were fashioned to discourage not merely acquisition at a discount of claims to be enforced against the debtor, but *trading* in securities, including *equity* securities.[26] This expansion of the restrictions on insider dealing emphasized the effort to avert divided loyalties and to eliminate the temptation to make managerial decisions in reorganization negotiations (and in the case of section 16(b), in corporate affairs generally) with an eye to the impact of such decisions on the prices of corporate securities and the insider's profitable purchases, sales or trades.[27] This, of course, was designed in

[25] Section 249 of the Bankruptcy Act was said to be "in the main a codification of the rule already imposed by the courts in proceedings under § 77B." S. REP. No. 1916, 75th Cong., 3d Sess. 38 (1937). See also Otis & Co. v. Insurance Bldg. Corp., 110 F.2d 333, 335 (1st Cir. 1940); Testimony of Securities and Exchange Commissioner William O. Douglas, *Hearings on H.R. 6439, Subsequently Amended and Reintroduced as H.R. 6439, Before House Committee on Judiciary*, 75th Cong., 1st Sess. 184 (1937); *cf. In re* Midland United Co., 159 F.2d 340, 345 (3d Cir. 1947). Similarly, although its language is merely permissive [*cf. In re* Celotex Co., 12 F. Supp. 1 (D. Del. 1935)], § 212 has its roots in ancient equitable doctrine, from which a more rigid rule of accountability has been fashioned judicially. See *In re* Los Angeles Lumber Prod. Co., 37 F. Supp. 708, 710 (S.D. Cal. 1941); and cases cited *supra* note 11. See also *In re* Nazareth Fairgrounds & Farmers' Mkt., Inc., 296 F.2d 678, 684 (2d Cir. 1961), *cert. granted sub nom.* Wolf v. Weinstein, 369 U.S. 837 (1962); *In re* McEwen's Laundry, 90 F.2d 872, 873-74 (6th Cir. 1937); SEC, REPORT ON THE STUDY AND INVESTIGATION OF THE WORK, ACTIVITIES, PERSONNEL AND FUNCTIONS OF PROTECTIVE AND REORGANIZATION COMMITTEES (hereinafter called SEC PROTECTIVE COMMITTEE STUDY) pt. VIII, at 119-20 (1938).

[26] See *In re* Philadelphia & W. Ry., 64 F. Supp. 738 (E.D. Pa. 1946); compare *In re* Republic Gas Corp., 35 F. Supp. 300 (D. Del. 1936), *aff'd*, 118 F.2d 405 (3d Cir. 1941); *In re* Paramount Publix Corp., 12 F. Supp. 823 (S.D.N.Y. 1935), *rev'd*, 83 F.2d 406 (2d Cir. 1936). Accountability in such circumstances suggests a broader obligation than was generally imposed upon trustees. Compare Prudential Ins. Co. v. Libedar Holding Corp., 72 F.2d 395, 397-98 (2d Cir. 1934).

[27] Illustrations of the varied possibilities of insider manipulation of corporate affairs or of the reorganization process in order to facilitate profitable dealing for himself at the risk of injury to the corporation or its security holders, are set out in detail in the Securities and Exchange Commission's second Chenery decision, *In re* Federal Water Serv. Corp., 18 S.E.C. 231, 248-51 (1945). See also Derby Gas & Elec. Corp., 9 S.E.C. 686, 707-08 (1941). That § 16(b) of the Exchange Act was aimed, at least in part, at such practices is suggested by many references to them in its legislative history. See,

part to protect the corporation and security holders other than those dealing with the insider.[28] But the legislative pattern also reflected explicitly the judgment only rarely intimated by the courts—that all insider dealings, however innocent, should be discouraged in order to protect persons who were only selectively protected by the law of trusts—beneficiaries who sold to, or purchased from, the trustee.[29]

This effort to protect those who deal with the insider appears to be derived more from the considerations underlying the traditional disclosure requirements imposed upon a trustee seeking to purchase the interest of a cestui, than from the premises on which a trustee is forbidden to enforce claims he has purchased at a discount. Such disclosure obligations,[30] which in any event were far from uniformly included among corporate insiders' fiduciary obligations when buying or selling securities,[31] were apparently

e.g., Hearings on Stock Exchange Practices, Before Senate Committee on Banking and Currency on S. Res. 84, S. Res. 56 and S. Res. 97, 73d Cong., 1st Sess., pt. 15, at 6555-60 (1934); S. REP. No. 1445, 73d Cong., 3d Sess. 57-68 (1934); S. REP. No. 792, *id.* at 9; H.R. REP. No. 1383, *id.* at 13-14. See also report of SEC on PROPOSALS FOR AMENDMENT TO SECURITIES ACT OF 1933 AND THE SECURITIES EXCHANGE ACT OF 1934, made to the House Committee on Interstate and Foreign Commerce, 77th Cong., 1st Sess. 36-38 (1941); *Hearings Before House Committee on Interstate and Foreign Commerce on H.R. 4344, H.R. 5065 and H.R. 5832*, 77th Cong., 1st Sess. 1254-60 (1941).

28 With respect to § 16(b), see note 27 *supra*. See also Birnbaum v. Newport Steel Corp., 193 F.2d 461, 463-64 (2d Cir.), *cert. denied*, 343 U.S. 956 (1952); Silverman v. Re, 194 F. Supp. 540 (S.D.N.Y. 1961). With respect to the Holding Company Act, see the Chenery decisions and others cited note 7 *supra*. With respect to chapter X, the SEC PROTECTIVE COMMITTEE STUDY from time to time indicates that protection of those security holders with whom the insider does not deal is one of the objectives of prohibiting insider trading in contemplation of or during bankruptcy reorganization. See SEC PROTECTIVE COMMITTEE STUDY, pt. II at 517-18, pt. VIII, at 440 (1937). See also Otis & Co. v. Insurance Bldg. Corp., 110 F.2d 333 (1st Cir. 1940); *cf. In re* Bridgford Co., 237 F.2d 182 (9th Cir. 1956), *cert. denied*, 325 U.S. 1005 (1957); *In re* Philadelphia W. Ry. Co., 64 F. Supp. 738, 741 (E.D. Pa. 1946); *In re* Los Angeles Lumber Prod. Co., 46 F. Supp. 77, 92 (S.D. Cal. 1941). Compare Meyers, *Appellate Review of Attorney Allowances in Chapter X Reorganizations*, 53 COLUM. L. REV. 1039, 1043-44 (1953).

29 With respect to chapter X, see testimony of Commissioner William O. Douglas, *supra* note 25; see also SEC PROTECTIVE COMMITTEE STUDY, pt. III, at 132-52, pt. II, at 315-51, pt. I, at 155-56 (1937); Note, *Conflict of Interests as a Factor in the Allowance of Representatives' Claims in Insolvent Corporate Reorganizations*, 106 U. PA. L. REV. 1139 (1958). *But cf.* Berner v. Equitable Office Bldg. Corp., 175 F.2d 218, 220 (2d Cir. 1949). That such is among the purposes of § 16(b) is apparent from the face of the provision. See also S. REP. No. 792, 73d Cong., 3d Sess. 8-10 (1934). Similar considerations also were authoritative in the administration of the Holding Company Act. See Second Chenery decision, *In re* Federal Water Serv. Corp., 18 S.E.C. 231, 256 (1915).

30 See, *e.g.*, Mansfield Hardwood Lumber Co. v. Johnson, 263 F.2d 748 (5th Cir.), *cert. denied*, 361 U.S. 885 (1959); BOGERT, *op. cit. supra* note 17, § 544, at 594; RESTATEMENT, TRUSTS §§ 170(2), 216 (1959); SCOTT, *op. cit. supra* note 17, § 216 at 1149; Scott, *The Fiduciary Principle*, 37 CALIF. L. REV. 539, 541-55 (1949).

31 See authorities cited note 3 *supra*.

deemed insufficient to protect public investors with whom insiders "traded" on impersonal securities markets or dealt during a bankruptcy reorganization. It was in fair part to overcome the necessity for resolving the difficult questions of enforcement and of proof which a rule directed only at demonstrated misuse of inside information would pose for buyers and sellers of securities in publicly-held corporations that the prophylactic principle theretofore invoked by courts in related contexts was inserted in section 16(b) and chapter X.[32]

II. RATIONALE OF THE RULE IN PARTICULAR CONTEXTS

A. *General*

The conclusions thus reached with respect to insiders dealing in their corporations' securities are at odds with their freedom to deal in such securities under otherwise prevailing norms. Those norms generally require proscriptions and remedies to be tailored to the evil to be deterred or to the injury to be compensated, rather than aimed broadly at behavior which might produce the evil or injury feared but is not shown to have done so in fact. Thus, they impose liability on the insider for misleading, or at most, on fiduciary premises, for failure to make full disclosure to, those with whom he deals;[33] but they do not make him account-

32 See testimony of Commissioner William O. Douglas, *supra* note 25. The SEC PROTECTIVE COMMITTEE STUDY, pt. II, at 341 (1937), after referring to "the difficulty of proving that particular purchases or sales were based on inside information" concluded: "To purge the committee field of the fundamental and almost irreconcilable conflict of interest arising as a result of trading, all purchasing and selling by committee members and their affiliated interests should be barred and outlawed. Any intermediate procedure will either involve too great a recession from the ancient standards of trusteeship or be too difficult of administrative application." See also Second Chenery decision, *In re* Federal Water Serv. Corp., 18 S.E.C. 231, 256 (1945); SEC PROTECTIVE COMMITTEE STUDY, pt. II, at 513-14 (1937); Testimony of Thomas G. Corcoran, *Hearings on S. Res. 84, S. Res. 56 and 97, supra* note 27, at 6557.

33 See note 3 *supra*. The expanded liability of insiders to those with whom they deal is predicated more on fiduciary relationships than on adumbrations from the law of fraud. See, *e.g.*, Mansfield Hardwood Lumber Co. v. Johnson, 263 F.2d 748 (5th Cir.), *cert. denied*, 361 U.S. 885 (1959); Hotchkiss v. Fischer, 136 Kan. 530, 16 P.2d 531 (1932); Hotchkiss v. Fischer, 193 Kan. 333, 31 P.2d 37 (1934); Dawson v. National Life Ins. Co., 176 Iowa 362, 157 N.W. 929 (1916); Jacquith v. Mason, 99 Neb. 509, 156 N.W. 1041 (1916); *cf.* Gratz v. Claughton, 187 F.2d 46, 49 (2d Cir.), *cert. denied*, 341 U.S. 920 (1951); Ward LaFrance Truck Corp., 13 S.E.C. 373 (1943). But compare SEC v. Capital Gains Bureau, Inc., 300 F.2d 745 (2d Cir. 1961); Conant, *supra* note 3. The resulting broad disclosure requirement meets a special need to eliminate a kind of bargaining inequality which is particularly inappropriate in the securities markets. In those markets, in contrast to many other areas in which the public or consumer (as distinguished from the specialist) deals, ascertainment of the value of the item traded—

able in the absence of some such demonstrable misconduct in inducing a sale or purchase. Similarly the corporation and other security holders are generally protected only from demonstrated injury such as the usurpation of a plainly available corporate opportunity, or deliberate wrongdoing such as mismanagement of corporate affairs or withholding or inflating dividends in order to affect the prices of its securities and so to enable the insiders to make advantageous purchases or sales.[34]

Over and above the personal interests of insiders, the investing public has an interest in preserving a fair measure of freedom for insiders to invest (and correspondingly to dispose of all or part of their investments other than by trading) in their corporations, so that, for example, management personnel may be attracted or retained or inspired, investors may be left free to seek control or to add to their controlling holdings without unnecessary restrictions on their liquidity, and to some extent so that the liquidity of corporate securities generally may be increased or at least maintained.[35] In the absence of special circumstances, such interests are generally deemed sufficient to preclude imposition of a rule of accountability without fault upon insiders who purchase or sell their corporation's securities. Those considerations are felt generally to outweigh the risk of subjecting outsiders to the hazards of dealing with insiders who cannot or will not disclose fully the relevant knowledge they possess,[36] and the corporation to the pos-

i.e., any particular security—tends to be difficult and to require a certain amount of study, for which knowledge of, and access to, relevant information are crucial. The insider's lawful monopoly of such information and of access thereto creates bargaining inequalities which are different from those resulting from disparities of wealth, temperament, experience, intelligence, etc., and which, if widespread or uncurbed, make impossible "a fair and honest market . . . which would reflect an evaluation of securities in the light of all available and pertinent data." Smolowe v. Delendo Corp., 136 F.2d 231, 235-36 (2d Cir.), *cert. denied*, 320 U.S. 751 (1943). See also Cady, Roberts & Co., CCH FED. SEC. L. REP. ¶ 76803 (1961).

34 See cases cited note 15 *supra*. See also Mayflower Hotel Stockholders' Protective Comm. v. Mayflower Hotel Corp., 173 F.2d 416, 424 (D.C. Cir. 1949); Lesnik v. Public Industrial Corp., 144 F.2d 968, 978 (2d Cir. 1944); Ashman v. Miller, 101 F.2d 85, 89-91 (6th Cir. 1939); Hawley v. Wells, 151 Kan. 539, 99 P.2d 784 (1940); Anderson v. Dyer, 94 Minn. 30, 101 N.W. 1061 (1904); Hechelman v. Geyer, 248 Pa. 430, 94 Atl. 188 (1915); White v. Texas Co., 59 Utah 180, 202 Pac. 826 (1921); Note, *Freezing Out Minority Shareholders*, 74 HARV. L. REV. 1630 (1961).

35 See SMITH, MANAGEMENT TRADING (1941) for discussion of the possible significance of insider trading on liquidity and price structure generally.

36 Even the requirement of full disclosure of relevant facts often will not entirely eliminate the insider's bargaining advantages over those with whom he deals. Apart from deliberate failure to meet the disclosure command [*cf.* Cities Serv. Co., 26 S.E.C. 678, 690-91 (1947)], enforcement of the requirement against the insider may not be

sibility that insiders will, in aid of their personal securities dealings, abuse their power in a manner too subtle to be practicably detected.[37]

But the conflict between the need for a fair measure of investment freedom for insiders and the need for protection of outsiders and the corporation from abuse of power and knowledge by an insider seeking to facilitate his securities dealings does not produce the same balance of social convenience in all circumstances. The rule embodied in section 16(b) and chapter X (and in the case law preceding it) is addressed to the special circumstances there described. In the former case, it rests on the differences that obtain between insider "trading" and insider "investment."[38] In the latter, it reflects the comparable differences between the relationship of the insider to the public security holder during normal times and that existing during reorganization or liquidation crises, and the relative acuteness of the temptations and opportunities for abuse of inside power and knowledge during such corporate crises, as distinguished from normal times.

B. *Section 16(b)*

Even on the assumption that increased management investment in the enterprise will ultimately benefit public investors—

feasible in impersonal markets [*but cf.* Cady, Roberts & Co., CCH FED. SEC. L. REP. ¶ 76803 (1961)]. And in any event some kinds of inside information, *e.g.*, potential but uncertain technical advances, trade secrets, intangible and often relatively long range estimates or judgments about the particular corporation or the industry with which it is connected, may not be communicable effectively to a buyer or seller without raising more problems than are solved. See Comment, 59 YALE L.J. 1120, 1148-49 (1950). Compare BERLE, STUDIES IN CORPORATION FINANCE 184-88 (1928); BERLE & MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY 320-25 (1932); Walker, *The Duty of Disclosure by a Director*, 32 YALE L.J. 637 (1923).

37 See, *e.g.*, Ashman v. Miller, 101 F.2d 85 (6th Cir. 1939); Dupont v. Dupont, 256 Fed. 129 (3d Cir.), *cert. denied*, 250 U.S. 642 (1919); Grubman v. American Gen. Corp., 130 N.J. Eq. 607, 23 A.2d 578 (1942); Lewin v. New York Ambassador, 189 Misc. 181, 61 N.Y.S.2d 492 (Sup. Ct. 1946), *aff'd*, 271 App. Div. 927, 67 N.Y.S.2d 706 (1947); Mannheimer v. Keehn, 41 N.Y.S.2d 542, 553-56 (Sup. Ct. 1943), *modified on another ground*, 268 App. Div. 813, 49 N.Y.S.2d 304, *amended*, 268 App. Div. 845, 51 N.Y.S.2d 750 (1944); Hauben v. Morris, 255 App. Div. 35, 5 N.Y.S.2d 721 (1938), *aff'd*, 281 N.Y. 652, 22 N.E.2d 482 (1939); *cf.* Seestedt v. Southern Laundry Co., 149 Fla. 402, 5 So. 2d 859 (1942). But compare National Bank & Trust Co. v. American Nat'l Bank, 217 Ind. 305, 311, 27 N.E.2d 764, 765-66 (1940).

38 See 2 Loss, *op. cit. supra* note 3, ch. 6C; Cook & Feldman, *Insider Trading Under the Securities Exchange Act*, 66 HARV. L. REV. 385, 612 (1953); Rubin & Feldman, *Statutory Inhibitions Upon Unfair Use of Corporate Information by Insiders*, 95 U. PA. L. REV. 468 (1947); Yourd, *Trading in Securities by Directors, Officers and Stockholders; Section 16 of the Securities Exchange Act*, 38 MICH. L. REV. 133 (1939); Comment, 59 YALE L.J. 510 (1950).

an assumption which has not gone without challenge[39]—it by no means follows that an insider's "trading" or speculation in his corporation's securities is similarly desirable. The rewards sought from such activity are not necessarily related to any solid improvement in the prosperity of the corporation. Insider speculation is not likely either to tie the insider into, nor to give him incentive to devote himself zealously to, the effective development of the enterprise's operating prosperity. Nor is it likely to give the public the confidence in the enterprise which might be derived from bona fide insider investment. In short, while such practices offer a mode of compensation to corporate insiders measured by the dollars of profit they make,[40] they offer little or nothing of the advantages to public security holders claimed for bona fide insider investment.[41]

On the other hand, Congress found, after extensive inquiry, that insider "trading" was often accompanied by certain evils—use of inside knowledge to overreach buyers or sellers and use of inside power to injure the corporation or to create misleading impressions of value, to the detriment both of those who deal with insiders and of the other security holders who suffer by the effect of such misconduct or by action in reliance upon the false impressions thus created.[42] To be sure, similar possibilities exist whenever an insider buys or sells securities. But both the opportunity and the temptation to indulge in them appear to be greater when the insider gets in and out (or vice versa) during a relatively short period of time than when he is required to hold his investment for a relatively long period and to run the risk of

39 See BERLE & MEANS, *op. cit. supra* note 36, at 225 n.6, 327, 329-30; Baker, *Incentive Compensation Plans for Executives*, 15 HARV. BUS. REV. 44 (1936).

40 BERLE & MEANS, *op. cit. supra* note 36, at 326-31; SEC 10TH ANN. REP. 50 (1945). Even this ground is lacking when the insider, instead of being an officer or director, is a controlling stockholder.

41 Moreover as a mode of compensation, trading profits offer the corporation's security holders none of the protection against over-compensation which accompanies the more conventional modes of compensation, *e.g.*, the requirement of disclosure of amounts involved, of board of director approval, and of fairness in the compensation such as some relation to the value of the services. *Compare* Berkwitz v. Humphrey, 163 F. Supp. 78, 89-93 (N.D. Ohio 1958), *with* Lieberman v. Becker, 155 A.2d 596 (Del. 1959).

42 See, *e.g.*, legislative history of Securities Exchange Act cited *supra* note 27. See also *Hearings Before House Committee on Interstate and Foreign Commerce on H.R. 4344, 5065 and 5832*, 77th Cong., 1st Sess. 25-26 (1941); SMITH, MANAGEMENT TRADING (1941).

contingencies he cannot so readily control.[43] The premises on which section 16(b) rests are that whatever good may come from leaving insiders free to engage in short-swing transactions which are not shown to be wrongful in particular cases is more than offset by the frequency with which such trading is in fact likely to be wrongful, the inherent difficulties of proving any wrongdoing, and the consequences to which such trading tends to lead.

Integral to the resultant imposition of sanctions on *all* short-swing transactions—even when insiders are not shown to have intended to "trade" or to have misled buyers or sellers, or to have misconducted corporate affairs for the purpose of facilitating their own trading—are two considerations. In the first place, there is, of course, the notion that it is difficult, if not impossible, to enforce any less extensive or more selective prohibition,[44] particularly (although not exclusively) in the case of impersonal transactions on stock exchanges. In the second place, there is the belief that in order to protect the integrity of the securities markets and the free flow of public capital to large corporate enterprise, it is necessary to keep corporate insiders not only virtuous but above suspicion when dealing in their corporation's securities.[45] Presumably, the decision to limit the sanction to the denial of profits in lieu of imposing penal or other consequences[46] is attributable in part to the fact that the sanction is to be visited

[43] See note 38 *supra.*

[44] See testimony of Thomas G. Corcoran, *supra* note 32. *But cf.* the treatment of a comparable problem of investment advisers in SEC v. Capital Gains Bureau, Inc., 300 F.2d 745 (2d Cir. 1961).

[45] See legislative history of § 16(b), note 27 *supra.* See also report of Special Committee on Securities Law Regulations of the American Bar Association, printed in *Hearings Before House Committee on Interstate and Foreign Commerce on H.R. 4344, H.R. 5065 and H.R. 5832,* 77th Cong., 1st Sess. 717 (1941): "A persistent cause of lack of public confidence in the exchanges has been the popular impression that they can be traded on profitably only by persons specially informed. Section 16(b) aids materially in the removal of reasons for that suspicion, and it also is in full accord with the principle that no person in a fiduciary relation should use information or opportunities coming to him because of his position for his own private profit. Until strong contrary proof shall be forthcoming, it is the committee's opinion that the public interest requires that Section 16(b) of the Exchange Act should not be changed." See also *id.* at 1254-62, 1319, 1341, 1411-15.

[46] The original Fletcher-Rayburn bill made purchases with the intention to resell within six months unlawful, in addition to providing civil remedies. *Hearings on S. Res. 84, S. Res. 56 and 97, supra* note 27, at 6556-57. Compare Rev. Rul. 61-115, 1961 INT. REV. BULL. No. 25, at 7. Compare also *In re* Nazareth Fairgrounds & Farmers' Mkt., Inc., 296 F.2d 678 (2d Cir. 1961), *cert. granted sub nom.* Wolf v. Weinstein, 369 U.S. 837 (1962).

on innocent as well as on tainted short-swing transactions by insiders.[47]

From time to time, questions have been raised as to whether the likelihood of such evils following from insider short-swing transactions and the difficulty of preventing or apprehending them are so great as to justify the broad sweep of the remedy thus prescribed. And suggestions have been made that public investors derive significant advantages from insider trading of which the unselective thrust of section 16(b) deprives them, that the sanction is irrational, and that in any event the provision is an invitation to champerty.[48] The SEC's answers to the principal of these arguments[49] has apparently satisfied Congress that the rule embodied in section 16(b) is preferable to any more selective deterrent.

47 Compare Niles, *Trustee Accountability in the Absence of Breach of Trust*, 60 COLUM. L. REV. 141 (1960).

48 See 2 Loss, *op. cit. supra* note 3, at 1087-90.

49 In its Report on Proposals for Amendments to the Securities Act of 1933 and the Securities Exchange Act of 1934 made to the House Committee on Interstate and Foreign Commerce of the 77th Congress, 1st Session on August 7, 1941, the Commission commented as follows (pp. 36-38):

"It has been asserted that the provision [§ 16(b)] operates to deter insiders from making purchases to retard a falling market. But if an insider really wishes to cushion a decline, section 16(b) does not make it unlawful for him to do so. It is only where the insider makes a profit within the relatively short period of 6 months that his profit is required to be turned over to the corporation. Furthermore, that particular argument for repeal of section 16(b) presupposes that insiders would act to bolster the market by trading primarily against the trend, buying in weak markets and selling in strong markets. But, even if it be assumed that some corporate officials would so act, the mere fact that the activities of some trustees might be advantageous to their beneficiaries has never been considered an adequate reason for an abolition of the prohibition against self-dealing by trustees in trust property.

"Moreover, even if insiders would purchase in order to bolster the market, there is serious doubt whether investors would always be benefited. If the market continued to fall after the insiders had attempted to support the market, their activities would have injured those stockholders who had been induced not to sell and those new investors who had been induced to purchase by the false appearance of stability thus created. . . . The deterrent of section 16(b) to in-and-out trading by insiders is . . . consistent with the time-honored doctrine that a trustee must avoid any activity which involves even a remote possibility of a conflict of interest between his fiduciary obligations and his personal self-interests. The Commission is convinced that any legislation which sought to distinguish between situations where inside information is actually used and those where it is not used would be self-defeating because of the inherent difficulties of establishing the use of inside information in particular cases.

"It may also be urged with much force that even to the extent that section 16(b) may permit the recovery of profits made without the use of inside information it achieves a highly desirable objective. It is to be doubted whether the interests of security holders are benefited when the attention of their officers and directors is diverted from the corporation's affairs to stock market speculation in its securities. . . .

". . . Although the reporting of transactions may in some cases operate as a deterrent, it cannot be expected to prevent insiders from taking advantage of inside information.

C. *Reorganizations*

Factors not unlike those which are thus reflected in the congressional policy on insider "trading" operate on insider dealings in their corporation's securities during reorganizations in bankruptcy and under the Holding Company Act. And similar judgments are embodied in the rules fashioned to meet the problems raised by such dealings. Indeed, insider purchases pending a liquidation or during a reorganization have certain aspects which are similar to the "trading" at which section 16(b) is aimed.[50] The insider may, of course, be purchasing securities in the old enterprise with an eye to the long-term prosperity of the ultimately reorganized business, if it continues and there is no liquidation. But the imminence of the reorganization exchange suggests that when he purchases during or in contemplation of a reorganization he may also be interested in the shorter term increment attributable to fluctuations in security prices caused by transient reorganization considerations. To allow him such an increment—whether in the form of realized cash gain or of increased value in new securities—is to reward the insider with trading profits based on reorganization activities rather than with investment profits. On the other hand, a rule which denies an insider the profit on the reorganization exchange does not preclude him from enjoying the long-run improvement of the company, so that if he purchases for investment, he will not be denied the benefits of a wise choice or of his own efforts as a manager of the enterprise.

To be sure, by denying the insider the exchange profit, his

The temptations and the potential returns are too great to be effectively overcome merely by subsequent publicity. It was because the Congress did not believe that publicity alone would be sufficient that it defined the standard in section 16(b)—that insiders, because of their fiduciary relationship, should not trade in-and-out in the securities of their companies for their personal gain. The consequences of failing to comply with this standard are not penal. The section does not make insiders' trading unlawful; it does not even subject insiders to injunctive proceedings. It simply guards against the use of inside information since such information is not the personal property of the insiders themselves and since any profits resulting from its use belong to the insiders no more than does the inside information itself."

50 The reorganization exchange has been held to be a purchase or a sale within § 16(b). Blau v. Hodgkinson, 100 F. Supp. 361 (S.D.N.Y. 1951); Blau v. Mission Corp., 212 F.2d 77, 80 (2d Cir.), *cert. denied,* 347 U.S. 1016 (1954); *cf.* Roberts v. Eaton, 212 F.2d 82 (2d Cir.), *cert. denied,* 348 U.S. 827 (1954) (recapitalization). Compare rules 16b-6 & 16b-7 under the Securities Exchange Act of 1934, 48 Stat. 896, 15 U.S.C. § 79 (1958). See generally 2 LOSS, SECURITIES REGULATION 1066-75 (2d ed. 1961); Cook & Feldman, *supra* note 38, at 626-28; Meeker & Cooney, *The Problem of Definition in Determining Insider Liabilities Under Section 16(b),* 45 VA. L. REV. 949, 975-79 (1959).

enthusiasm in working for consummation of an advantageous reorganization may be diluted. But such dilution of enthusiasm is apt to be marginal in the case of a controlling security holder who, by definition, starts with a substantial investment. And if, as is doubtful, it may be more significant in the case of an officer or director, the question of encouraging investment by such personnel during reorganization is clouded by the problems arising from making them owners of particular securities when the process of reorganization may mature substantial conflicts between the interests of different classes of security holders.[51]

If the benefits to public investors from encouraging additional insider investment in the enterprise during a bankruptcy reorganization crisis are not apt to be as great as the benefits expected during normal times when the insider's efforts are focused primarily on improvement of operations,[52] both the opportunity and the temptation to abuse inside power and knowledge are apt to be greater during such a crisis. Bankruptcy reorganization creates a more congenial atmosphere than usually obtains for substantial fluctuation in the prices of a corporation's securities. Whether the crisis will result in liquidation or reorganization, it will almost inevitably culminate in an exchange of outstanding securities, either for underlying assets or for new participations. Attention is thus focused on what will be given for the outstanding securities; and the prices of those securities will respond not merely to the ultimate economic prospects of the enterprise and changes in, or rumors about, such prospects, but to proposed plans of reorganiza-

51 Whatever may be the problems for insiders in reconciling conflicting security-holder interests during normal operations [see, *e.g.*, Second Chenery decision, *In re* Federal Water Serv. Corp., 18 S.E.C. 231, 251 (1945); BERLE & MEANS, *op. cit. supra* note 36, bk. II, chs. II & III], during a reorganization, when security-holders' claims have effectively matured, to encourage management to purchase one rather than another class of securities is plainly at odds with the purpose of encouraging management investment for the benefit of all classes of security holders. Compare Greene, *Fiduciary Standards of Conduct Under the Investment Company Act of 1940*, 28 GEO. WASH. L. REV. 266, 284 (1959); SEC PROTECTIVE COMMITTEE STUDY, pt. VIII, at 440 (1937): "Even more dangerous to security holders [than trading on the basis of "inside" information] is the possibility of committee members becoming primarily interested because of trading activities in a security issue of the debtor other than that represented by their committee. The inevitable result is failure on their part in the first duty of persons in the fiduciary position of committeemen, which is to advance the interests of the persons whom they represent." See also SEC PROTECTIVE COMMITTEE STUDY, pt. II, at 517-18, pt. VII (1937); SEC, REPORT ON INVESTMENT TRUSTS AND INVESTMENT COMPANIES, pt. III, ch. IV (1940).

52 *Cf.* L. Hand, J., dissenting, *In re* Calton Crescent Hotel Co., 173 F.2d 944, 952 (2d Cir. 1949), *aff'd*, 338 U.S. 304 (1950).

tion, to alterations in proposed exchange ratios, to delays in consummating proposed exchanges, and to reports and rumors of any such matters.

By the same token, the shift in the emphasis of insiders' responsibilities from operational considerations to marshalling assets and negotiating changes in the participations of security holders whose claims have matured[53] is accompanied by increased opportunities and temptations to abuse inside power and knowledge without detection. Those in a position, either as management or as controlling security-holders, to formulate or participate in formulating reorganization plans, to propose amendments to them, to conduct negotiations on exchange ratios, to control the timing of such exchanges and the timing and content of reports on such activities, in addition to making the normal business judgments involved in the conduct of the corporate business (determining dividend policies, accounting techniques, maintenance policies, etc.), are in a position to make a concentrated impact on the prices at which the market will assess the worth of the corporation's securities. Similarly, the advance information of proposed action or reports which an insider will acquire during such a period is likely to be of unusual value in any market transactions he may attempt for his personal benefit.[54]

Finally, abuses of inside power or knowledge are no less difficult to detect during such corporate crises than normally. Rather, the problem of determining either whether the insider is buying or selling in reliance on special knowledge or whether he is guiding reorganization or liquidation negotiations with an eye toward affecting prices of securities so that he can trade profitably, is apt to be more acute when the prices of securities may be affected substantially by so many subtle and intangible factors that are not present during normal operations.[55]

It was in deference to these considerations that courts, and ultimately Congress and the Securities and Exchange Commission, fashioned rules to discourage insiders from purchasing claims at a discount or otherwise dealing in securities—however innocently—when their corporations were in, or on the verge of, insolvency

53 See note 57 *infra.*

54 See SEC PROTECTIVE COMMITTEE STUDY, pt. I, at 155-56, pt. II, at 315-41 (1937).

55 Second Chenery decision, *In re* Federal Water Serv. Corp., 18 S.E.C. 231, 256-57 (1945). See Comment, 59 YALE L.J. 151, 156 (1950).

liquidation or insolvency or Holding Company Act reorganization. The dominant notion is that during such corporate crises public investors can be protected adequately only if insiders are discouraged from any and all dealings in securities rather than merely penalized for transactions of demonstrated impropriety.

III. EXTENSION OF THE RULE TO COMPARABLE CONTEXTS

To recognize that insider transactions (other than trading) in securities of publicly-held corporations are, and should be, censurable normally only on a selective basis is not to deny that the considerations which impelled courts, Congress and the SEC to adopt a policy of broader accountability for profits from such dealings in certain specified circumstances may require a similar policy in cognate circumstances.[56] Thus, in all relevant respects similar to forced reorganizations under chapter X or the Holding Company Act are voluntary mergers and consolidations, sales of substantially all the assets of a corporation and reinvestment of the proceeds, and substantial recapitalizations or liquidation. The radical alterations thus occurring in the enterprise effect in substance, and generally in form, a change in the nature of the security-holder's participation. As a result of a recapitalization he will receive a new kind of participation; in the case of a merger or consolidation he will receive a new security in a new enterprise. When assets have been sold and new businesses are sought for investment of the resulting pool of capital, while the investor will not receive a new security, he will become an investor in a totally different business. In a liquidation he will receive his share of the under-

[56] *E.g.*, the reasons for seeking to discourage—by requiring accountability for profits derived from—insider "trading" in stock of corporations listed on stock exchanges seem no less applicable to insider "trading" in any securities of publicly-held corporations on other organized markets, such as the over-the-counter markets, whose scope and volume of transactions have increased considerably since 1934. Those reasons and countervailing considerations are discussed in the congressional Hearings and Committee Reports cited in Loss, *op. cit. supra* note 9. It may also be noted that securities of considerably more speculative character than those traded on exchanges tend to be traded in the over-the-counter markets; and those markets are often the initial medium for trading in the securities of corporations which have not previously issued securities to the public and whose managements or controlling stockholders are not entirely alert to their responsibilities to public security holders. Compare Address by SEC Chairman, San Francisco, March 23, 1962, quoted in SEC Digest, March 23, 1962. To the extent that the full panoply of reporting and regulatory requirements governing the activities of insiders of corporations whose securities are traded on exchanges has not been extended to the over-the-counter markets, there is even more reason for discouraging insider trading on those markets.

lying assets or the proceeds of the sale of all or part of them. Because of the magnitude of the alterations thus being made in the structure or character of the enterprise and in security holders' rights, both immediately prior to and during the period of such crises, there is apt to be an increased volatility in the prices of the enterprise's securities, which will respond to considerations stemming from the potential readjustment rather than merely from normal operating developments.

At the same time, the function and responsibility of insiders vis-à-vis other security holders changes.[57] Thus, for example, the use of a corporation's cash to purchase its debt at a price below face value or its stock at a price below asset value while it is a going concern raises different problems and reflects different considerations than would similar purchases when the corporation is being liquidated or its business is being converted. Hence, the propriety of an insider's purchases of such debt or stock is to be assessed differently in the light of the corporation's different requirements and of the possibilities of conflict with the imminently maturing claims of his fellow security holders, whether of the same or of a different class.[58]

By the same token, the insider's opportunity to affect securities prices artificially, sometimes at the risk of injury to the corporation and fellow security holders, increases substantially. In addition to his power to affect the dividend rate or even the flow of earnings during the pendency of the readjustment crisis, there are the possibilities of altering the terms of the merger exchange during the bargaining process, of delaying consummation of the merger, or even of discontinuing the negotiations. Similarly, within fairly broad areas, insiders can delay or accelerate the purchase of

57 It may also be noted that officers, directors or controlling stockholders often fill, during a voluntary reorganization crisis, the additional roles of the fiduciaries covered by §§ 249 and 212 of ch. X. *Cf. In re* Nazareth Fairgrounds & Farmers' Mkt., Inc., 296 F.2d 678 (2d Cir. 1961), *cert. granted, sub nom.* Wolf v. Weinstein, 369 U.S. 837 (1962). Although it is far from universally recognized, the insider's altered position during a corporate crisis has been noted with respect both to those with whom he deals [*e.g.*, Westwood v. Continental Can Co., 80 F.2d 494 (5th Cir. 1935); Dunnett v. Arn, 71 F.2d 912 (10th Cir. 1935); Dutton v. Barnes, 162 Minn. 430, 203 N.W. 414 (1925); Sautter v. Fulmer, 258 N.Y. 107, 179 N.E. 310 (1932); Allen v. Hyatt, 30 T.L.R. 444 (P.C. 1914)] and with respect to his corporation and its other security holders. Compare note 15 *supra*. See also Bond & Mortgage Guar. Co., 303 N.Y. 423, 103 N.E. 721 (1952); Middle W. Corp., 27 S.E.C. 195, 224 (1947); Cities Serv. Co., 26 S.E.C. 678, 690-91 (1947).

58 See *In re* Engineers Pub. Serv. Co., 221 F.2d 708, 713 (3d Cir. 1955). See also note 51 *supra*.

a new business with the liquid assets obtained from the sale of the old business, and have significant advance knowledge of the kind of new business for which purchase negotiations are commencing or the likelihood and terms of sales of assets or settlements of controversies during a prolonged liquidation. Judicious timing of financial reports and statements of progress or lack of progress in such matters effectively adds to the insider's power and potential ability to utilize advance knowledge of, or to affect, a relatively volatile market.

The significance of such factors is accentuated by the difficulty of detecting culpable misconduct or enforcing a rule of full disclosure by insiders buying or selling corporate securities or trading in them at such times. If during or in contemplation of merger negotiations an insider purchases securities, it may, and often will, be virtually impossible to determine whether his conduct of the merger negotiations is, for example, merely a cautious response to legitimate bargaining considerations or is designed to affect prices momentarily to the detriment of the sellers and possibly of other security holders, or whether he is taking advantage of inside knowledge, or whether he is depriving the corporation and its remaining security holders of a legitimate bargain purchase or is failing to exercise his best efforts to obtain such a bargain for them. Additional problems arise if the corporation has several classes of securities and the officer or director buys or sells securities of one, but not of another, class. Similarly, if he sells during the merger negotiations, difficult questions are presented in determining whether he is relying on inside information unknown to the buyer, or conducting negotiations so as artificially to raise prices in order to facilitate his sale at the expense of the buyer and of other security holders.[59] Transactions by insiders

[59] The complete termination of an insider's investment interest in his corporation presents a somewhat different problem than does the sale of merely a portion of his interest. Whether the insider holds a controlling interest or is simply a member of management, with a relatively small investment, who is resigning, his freedom to "get out" ought arguably to be less restricted than his freedom to dispose of a portion of his investment while continuing to remain an insider. The argument is that the public may have an interest in facilitating the departure of one controlling group or management and the acquisition of control by a new group. See Hill, *The Sale of Controlling Shares*, 70 HARV. L. REV. 986 (1957); Katz, *The Sale of Corporate Control*, 38 CHICAGO B. RECORD 376 (1957). To the extent that insiders wish to terminate their relationship with the corporation, denying them any increment in the price of their securities which might be attributable to the corporate crisis or to their sale of control, will tend to have a discouraging effect on such departure. But whatever point this argument may

when a recapitalization is planned give rise to many of the same questions.

Comparable problems also arise when the corporation is in liquidation or has sold its assets and is seeking a new investment. If there is a delay in the liquidation or in reinvesting the proceeds, the prices of its securities will normally fall. For an insider to purchase during such a period raises questions as to whether he is relying on inside information so that in effect he misleads the seller, or whether he is competing unfairly with the corporation and its remaining security holders,[60] or failing to exercise his best efforts to acquire a new business or speed the liquidation, or is otherwise injuring those appropriately regarded as his beneficiaries. Such questions pose inquiries which cannot practicably produce answers. Thus, for example, when a corporation has only liquid assets which it is seeking to reinvest in a new business or businesses, it will be the unusual case in which evidence will be available to establish with reasonable clarity whether the failure to find such a business promptly is a function of the insiders' exercise of due caution or is affected by their desire to facilitate advantageous purchases of corporate securities for themselves. Similarly in the case of an enterprise in liquidation, proof will be difficult, if not impossible, for those seeking to ascertain whether delay in the sale of assets or the wind-up of tax controversies or the like is attributable to appropriate care in the liquidation process or to self-interest in acquiring the corporation's securities cheaply.[61]

The public interest in the integrity of the securities markets and of insiders' conduct of corporate affairs which impels restrictions on insiders securities dealings, however innocent, during insolvency and Holding Company Act reorganization is present dur-

have in the case of those who seek to sell control, it is of doubtful merit when only a portion of the insider's investment is being sold, or otherwise dischargeable members of management are selling their holdings. On sale of control, see generally Berle, *"Control" in Corporate Law*, 58 COLUM. L. REV. 1212, 1220-22 (1958); Jennings, *Trading in Corporate Control*, 44 CALIF. L. REV. 1 (1956); Leech, *Transactions in Corporate Control*, 104 U. PA. L. REV. 725 (1956). Compare cases dealing with the corporation's litigable "interest" or lack thereof in dealings in its stock during a struggle for control among its stockholders. See Note, 62 COLUM. L. REV. 1096 (1962).

60 *I.e.*, shouldn't the available cash be used to purchase corporate securities which are selling at a discount?

61 *Compare* Bond & Mortgage Guar. Co., 303 N.Y. 423, 431-32, 103 N.E.2d 721, 726 (1952), *with* Victor v. Hillebrecht, 405 Ill. 264, 90 N.E.2d 751, *cert. denied*, 339 U.S. 980 (1950).

ing voluntary corporate readjustment crises, with little, if any, difference in degree.[62] Indeed, other factors suggest a somewhat stronger basis for prophylactic discouragement of insider dealings or trading during such voluntarily created corporate crises. To the extent that regulatory approval is not required, the protection which might flow from supervision or examination of the sale of assets and change of business or of the merger or liquidation process by an administrative agency is absent. And to the extent that insider purchasing and selling is not required to be reported (*e.g.*, if the corporation's securities are not listed on a securities exchange) and no public security holder representation exists, the protection flowing from participation by organized security holder groups, which is typically found in bankruptcy or Holding Company Act reorganization, is also lacking.[63] The resultant ability of the insider to function free from the inquiring eye of either a regulatory agency or outside security holders may be as desirable as it appears necessary. But it unquestionably accentuates the problems created by his purchases and sales during such times.[64]

IV. THE CASE LAW AND OBJECTIONS TO EXTENSION OF THE RULE

From the point of view of persons dealing with insiders, the solution so far evolved for such problems is the requirement of full disclosure by the latter, although even that prescription is

[62] On the other hand, the case law, at least in non-crisis situations, relieves insiders who issue misleading statements or fail to disclose material facts from liability in damages to security holders who do not deal with them [see Donovan v. Taylor, 136 F. Supp. 552 (N.D. Cal. 1955); Joseph v. Farnsworth Radio & Television Corp., 99 F. Supp. 701 (S.D.N.Y. 1951), *aff'd*, 198 F.2d 883 (2d Cir. 1952); Comment, 42 VA. L. REV. 537, 570-72 (1956); Note, 4 STAN. L. REV. 308 (1952). Compare Fischman Raytheon Mfg. Co., 188 F.2d 783 (2d Cir. 1951), and 3 Loss, SECURITIES REGULATION 1767-97 (2d ed. 1961)] and from accountability to their corporations for profits from securities transactions made on the basis of such statements or omissions. [Newman v. Baldwin, 13 Misc. 2d 898, 179 N.Y.S.2d 19 (Sup. Ct. 1958); Leffert v. Marcus, 12 Misc. 2d 1097, 174 N.Y.S.2d 546 (Sup. Ct. 1958), *rev'd on other grounds*, 7 App. Div. 2d 989, 183 N.Y.S.2d 886 (1959); *but cf.* Stella v. Kaiser, 82 F. Supp. 301 (S.D.N.Y. 1948)]. However, comparison of Birnbaum v. Newport Steel Corp., 193 F.2d 461 (2d Cir.), *cert. denied*, 343 U.S. 596 (1952), with Perlman v. Feldmann, 219 F.2d 173 (2d Cir.), *cert. denied*, 349 U.S. 952 (1955), suggests that while security holders who simply retain their holdings during a corporate crisis may not be entitled to protection against insiders on the theory of fraud, they may be entitled to an accounting on the theory of breach of trust or divided loyalty.

[63] Compare SEC PROTECTIVE COMMITTEE STUDY, pt. VII (1938); SEC, REPORT ON INVESTMENT TRUSTS AND INVESTMENT COMPANIES, pt. III, ch. IV, at 1414-15 (1940).

[64] *Cf.* Second Chenery decision, *In re* Federal Water Serv. Corp., 18 S.E.C. 231, 251-52 (1945).

not uniformly accepted as a permissible limitation on insiders' freedom to buy or sell their corporation's securities. But the relative frequency of litigation based on failure to disclose the imminence of voluntary mergers, sales of control, or the like, underscores the temptation to overreach "outsiders" in such circumstances.[65] And the unusual difficulty of defining, let alone enforcing, adequate disclosure at such times suggests that a requirement of disclosure will not be a feasible or effective answer to the problem of controlling that temptation.[66] Moreover, to the extent that outside buyers and sellers are protected only if they are in privity with insiders who purchase or sell, the insider is not liable for failure to disclose material facts to those who may be induced, by his misleading statements or omissions or actions, to buy or sell securities but who do not deal with the insider in doing so. In short, however rational a requirement of disclosure may be to protect buyers or sellers, it is doubtful that it is any more adequate during voluntary reorganization or business change-over crises in the affairs of publicly-held corporations than it was found to be during bankruptcy reorganization.[67]

65 The "special circumstances" doctrine, through which the full disclosure rule often makes its appearance, was developed judicially in order to compel insider disclosure of precisely such special circumstances as an impending merger, sale of assets or liquidation. See BALLANTINE, CORPORATIONS 213 (2d ed. 1946); BERLE & MEANS, *op. cit. supra* note 36, at 324; 3 FLETCHER, CYCLOPEDIA OF CORPORATIONS 786-90 (1947); STEVENS, CORPORATIONS 690-705 (2d ed. 1949).

66 Not only is there the problem of how to make, or what constitutes, adequate disclosure about shifting and uncertain negotiations for a sale of assets or purchase of a business or terms of a merger, but the very fact of disclosure may itself affect the negotiation process significantly—and adversely. Compare note 36 *supra*. See Daum & Phillips, *The Implications of Cady Roberts*, 17 BUS. LAW. 939, 953 (1962). Hence, a rule discouraging insiders from all dealing in such circumstances, by denying them their profits, may well be the only adequate remedy to protect "outside" sellers or buyers. To be sure, the effect of such a rule will be to restrict the opportunities for an outside security holder to deal with insiders more narrowly than comparable opportunities for a fully informed and competent beneficiary of a trust to deal with the trustee. The existence of such a rule need not permit an outside security holder to recover from the insider with whom he has dealt in an action on his own behalf unless he proves actual misbehavior or overreaching. *Compare, e.g.*, Dunnett v. Arn, 71 F.2d 912 (10th Cir. 1935), *with* Roby v. Dunnett, 88 F.2d 68 (10th Cir.), *cert. denied*, 301 U.S. 706 (1937). See also Conant, *Duties of Disclosure of Corporate Insiders Who Purchase Shares*, 46 CORNELL L.Q. 53 (1960).

67 If disclosure of the relevant facts is an inadequate or infeasible remedy to protect "outside" buyers or sellers in such contexts, the suggestion that the insider should refrain from dealing in his corporation's securities during the readjustment crisis in order effectively to protect them is not without parallel. As the Securities and Exchange Commission has pointed out, if a broker (whose fiduciary obligations to those with whom he deals have never been deemed as rigorous as an "insider's comparable obligations") is unable to effect appropriate disclosures of inside information in dealing on

From the point of view of the corporation and its remaining security holders, the scope of insiders' obligations during such readjustment crises has not been adequately defined either by case law or by statute. Since the insider can substantially influence, and often completely determine, corporate action during such a crisis, the question is whether he should be permitted to enjoy personal profits from security dealings—profits which may well be unavailable for outsiders[68]—if to acquire such profits he may have to make decisions in his corporate capacity which are indifferent to or in conflict with, the interests of the corporation and his fellow security holders.

If treated narrowly, as a question of corporate opportunity, the problem may be analogized to the situation in which the corporation is apparently unable to exploit a potential opportunity because of lack of funds, because of some legal obstacle, or because the person offering the opportunity is purportedly unwilling to deal with it, and the insider takes advantage of the corporate opportunity for his own benefit. Despite frequent pious platitudes to the contrary, neither legislatures nor courts have seen fit to deprive the insider in all, or indeed in most, such circumstances of the temptation to choose between his interest and the interest of the recognized beneficiaries by prescribing a universal rule denying him the fruits of such extraneous activities when they have not demonstrably harmed the corporation or its other security holders.[69] However, from time to time a court will require

an exchange, "all . . . [he] need do is keep out of the market until the established procedures for public release of the information are carried out . . . ." Cady, Roberts & Co., CCH FED. SEC. L. REP. ¶ 76803, at 81019 (1961).

68 *E.g.*, to the extent that the insider is in a position to realize the discount between the asset value and the market price of his corporation's stock by compelling liquidation of the enterprise, he has an intrinsic advantage over outside security holders (with respect to the purchase of securities) by reason of his "control" position. A court of equity could well preclude him from exploiting his advantage during a corporate crisis. Compare Perlman v. Feldmann, 219 F.2d 173 (2d Cir.), *cert. denied*, 349 U.S. 952 (1955) and similar sale-of-control cases discussed in authorities collected note 59 *supra;* see also cases cited note 70 *infra*.

69 See Carrington & McElroy, *The Doctrine of Corporate Opportunity*, 14 BUS. LAW. 957 (1959); Fuller, *Restrictions Imposed by Directorship Status on Personal Business Activities of Directors*, 26 WASH. L. REV. 189 (1941); Ramsey, *Directors Power To Compete with His Corporation*, 18 IND. L.J. 293 (1943); Walker, *Legal Handles Used To Open or Close the Corporate Opportunity Door*, 56 NW. U.L. REV. 608 (1961); Comment, 31 CALIF. L. REV. 188 (1943); Note, 39 COLUM. L. REV. 219 (1939); Note, *Corporate Opportunity*, 74 HARV. L. REV. 765 (1961); Note, 54 HARV. L. REV. 1191 (1941); Note, *Statutory Sanctions for Conduct of Corporate Directors*, 26 IOWA L. REV. 334 (1941);

an insider to account for his profits even in the absence of a showing of harm,[70] on the theory that although the corporation might be unable itself to exploit a particular opportunity, the insider should be denied the right to exploit it and the concomitant temptation to inhibit the corporation from making every effort to do so.[71]

Thus in the classic case of *Irving Trust Co. v. Deutsch*,[72] which involved an effort to compel directors to account for profits from their acquisition and subsequent sale of stock of a company which their own corporation had contracted to purchase and required for its successful operation, the directors were not relieved of accountability by their claim that their corporation had been financially unable to purchase the stock. The court rejected this defense on the ground that "if directors are permitted to justify their conduct on such a theory, there will be a temptation to refrain from exerting their strongest efforts on behalf of the corporation since . . . an opportunity of profit will be open to them personally."[73] Similarly in *L. A. Young Spring & Wire Corp. v. Falls*,[74] a corporation's executives who acquired for themselves royalties

Note, 84 U. PA. L. REV. 1008 (1936); Note, 2 U. CHI. L. REV. 323 (1935); Note, 44 YALE L.J. 527 (1935).

[70] See, *e.g.*, Irving Trust Co. v. Deutsch, 73 F.2d 121, 124 (2d Cir. 1934), *cert. denied*, 294 U.S. 708 (1935) (alleged financial inability of corporation); Blum v. Fleishhacker, 21 F. Supp. 527 (N.D. Cal. 1937), *aff'd on this point*, 109 F.2d 543 (9th Cir. 1940); News-Journal Corp. v. Gore, 147 Fla. 217, 2 So. 2d 741 (1941); Farwell v. Pyle Nat'l Elec. Headlight Co., 289 Ill. 157, 124 N.E. 449 (1919); L. A. Young Spring & Wire Corp. v. Falls, 307 Mich. 69, 102, 11 N.W.2d 329, 341 (1943) (alleged refusal of third persons to deal with corporation); Young v. Columbia Oil Co., 110 W. Va. 364, 158 S.E. 678 (1931); Regal v. Gulliver, [1942] 1 All E.R. 378 (H.L.) (alleged illegality of corporate acquisition); and compare Jackson v. Smith, 254 U.S. 586 (1920) (receiver). See HORNSTEIN, CORPORATION LAW & PRACTICE §§ 441, 442 (1960); Note, 104 U. PA. L. REV. 242 (1955).

[71] It may be noted here that, in contrast to the benefits which might flow to public investors from direct dealings between insiders and their corporations or between corporations having common directors (see, *e.g.*, BERLE & MEANS, *op. cit. supra* note 36, at 230-31), it is difficult to envisage any benefit to the corporation from competitive activities by insiders, and it is generally much more difficult in such "corporate opportunity" cases to determine whether the insider in thus seeking his own personal gain has injured the corporation (*e.g.*, by depriving it of a valuable opportunity or by failing to exercise his best efforts on its behalf) than in direct dealing cases where the insider gives a *quid pro quo* whose value can be assessed. See, *e.g.*, Kaufman v. Wolfson, 153 F. Supp. 253, 255-56 (S.D.N.Y. 1957). Hence, in the latter type of case in contrast to the former, there is available a relatively feasible test of fairness to determine the propriety of any particular instance of self-dealing, and there is independent reason not to press for a rule discouraging all self-dealing.

[72] 73 F.2d 121 (2d Cir. 1934).

[73] *Id.* at 124.

[74] 307 Mich. 69, 11 N.W.2d 329 (1943).

under a patent which they should have acquired for their corporation, were not relieved of the duty to account to their corporation by the claim that the owner of the patent would not have dealt with the corporation. The court held such argument to be without merit "as it would open the door for any trusted executive to justify his breach of duty in acquiring interests adverse to those of his employer by merely claiming that his employer could not obtain such interests." In the circumstances, "it was at least their duty not to acquire interests . . . in the inventions for their personal profit."[75]

Insiders' dealings in their corporation's debts or securities present no less acute, and indeed considerably less tolerable, possibilities of conflict and temptation. Thus a principal consideration underlying the frequent extension of relatively wide latitude to insiders in competing with their corporations for business opportunities is the desirability of having as corporate directors men of large and varied business interests and affairs. The usual argument is that if insiders are unduly hampered by law in engaging in collateral business enterprises they will be deterred from becoming directors or officers. However valid such considerations may be, they do not obtain where the question turns on restricting only the insider's freedom to deal in his corporation's securities during corporate readjustment crises, rather than his freedom to acquire other business interests or investments generally. The significance of such narrowing factors has been recognized implicitly, if not explicitly, by both Congress and the courts in restricting insiders' securities transactions.[76]

If the scope of the insider's obligation is treated more broadly as a problem of divided loyalty in managing corporate affairs generally, analogous cases suggest, from time to time, that he should be held accountable for his profits from securities trans-

[75] *Id.* at 102, 11 N.W.2d at 341.

[76] *E.g.*, Congress, while imposing a categorical rule of accountability for profits from short-swing transactions by insiders of closed-end registered investment companies in securities of their companies [Investment Company Act of 1940, § 30(f), 54 Stat. 837, 15 U.S.C. § 80a-2g(f) (1958)] did not impose so rigorous a rule to govern their dealings in portfolio securities held by their corporations. See *Hearings Before a Subcommittee of the Senate Committee on Banking and Currency on S. 3580*, 76th Cong., 3d Sess. 302-04, 413-14 (1940). See Brown v. Bullock, 194 F. Supp. 207, 239 (S.D.N.Y.), *aff'd*, 294 F.2d 415 (2d Cir. 1961); *cf.* SEC v. Capital Gains Bureau, Inc., 300 F.2d 745 (2d Cir. 1961). See proposed rule R. 204-2(a)(12) under the Investment Advisers Act, Investment Advisers Act Rel. No. 120, Oct. 16, 1961.

actions which subject him to the temptation to mismanage or betray the corporation, even though he is not shown to have injured it.[77] Thus in *Ashman v. Miller*,[78] insiders who made several advantageous purchases of their publishing corporation's voting trust certificates from other holders, although not required to account for all such purchases, were required to turn over to the corporation, at cost plus interest, those certificates that they had purchased with funds borrowed from an enterprise supplying their corporation with newsprint, because they had thus placed themselves in a position where the supplier might be able to coerce them to continue the purchase of newsprint from it regardless of competitive prices in disregard of their duty to their corporation. Under such circumstances, the court felt that it would be both inequitable and against sound public policy to permit the directors to profit by the transaction. Indeed, on occasion, albeit not without substantial contrary authority, it has been suggested that sufficiently divided loyalty results from buying or selling securities during corporate crises other than bankruptcy to require insider accountability for profits even though he is not at fault and has caused no demonstrable injury.[79]

The respectable body of case law which has declined, or at least failed, to require such sweeping accountability involves, for the most part, closed corporations.[80] With respect to such enterprises it

[77] Ashman v. Miller, 101 F.2d 85, 91 (6th Cir. 1939); Thompson v. Mitchell, 128 Wash. 192, 222 Pac. 617 (1924). See also Brophy v. Cities Serv. Co., 31 Del. Ch. 231, 70 A.2d 5 (1948), and compare Bromschwig v. Carthage Marble & White Lime Co., 334 Mo. 319, 324-26, 66 S.W.2d 889, 892-93 (1933); Bailey v. Jacobs, 325 Pa. 187, 194, 189 Atl. 320, 324 (1937); Glen Allen Mining Co. v. Park Galena Mining Co., 77 Utah 362, 296 Pac. 231 (1931); Scott, *The Fiduciary Principle*, 37 CALIF. L. REV. 539, 546-55 (1949).

[78] Note 77 *supra*.

[79] Bond & Mortgage Guar. Co., 303 N.Y. 423, 103 N.E. 721 (1952). See also American Trust Co. v. California W. States Life Ins. Co., 15 Cal. 2d 42, 61-64, 98 P.2d 497, 507-08 (1940); Harbor Plywood Corp., Inv. Co. Act Rel. No. 3427, Feb. 16, 1962; *but cf.* Gallagher v. Pacific-American Co., 97 F.2d 193 (8th Cir. 1938). Compare Perlman v. Feldmann, 219 F.2d 173 (2d Cir.), *cert. denied*, 349 U.S. 952 (1955); Commonwealth Title Ins. & Trust Co. v. Seltzer, 227 Pa. 410, 76 Atl. 77 (1910).

[80] *E.g.*, Beedle v. Campbell, 100 F.2d 798 (8th Cir.), *cert. denied*, 307 U.S. 631 (1939); Bisbee v. Midland Linseed Prod. Co., 19 F.2d 24, 28-29 (8th Cir. 1927); Hart v. Brown, 77 Ill. 226 (1875); Hart v. Bell, 222 Minn. 69, 23 N.W.2d 375 (1946); Beaumont v. Folsom, 136 Neb. 235, 285 N.W. 547 (1939); Adams v. Mid-West Chevrolet Corp., 198 Okla. 461, 469-70, 179 P.2d 147, 157 (1947); McGeoch Bldg. Co. v. Dick & Rueteman Co., 253 Wis. 167, 172-73, 33 N.W.2d 252, 255, *rehearing denied*, 253 Wis. 177, 33 N.W.2d 864 (1948); *but cf.* Bramblet v. Commonwealth Land & Lumber Co., 26 Ky. L. Rep. 1176, 1179-80, 83 S.W. 599, 602 (Ct. App. 1904); McManus v. Durant, 168 App. Div. 643, 657, 154 N.Y. Supp. 580, 590 (App. Div. 1915).

is generally appropriate and feasible to enforce insiders' fiduciary obligations by narrower strictures. Insiders in closely-held ventures are able to communicate more effectively with their investors, and the latter are more likely than investors in publicly-held enterprises to be able to exercise meaningful scrutiny, if not supervision, over the former. Hence, the high standards of conduct prescribed for insiders in cases such as *Hotchkiss v. Fischer*,[81] and *Jacquith v. Mason*,[82] with respect to dealings with outside buyers and sellers, may be satisfied by requiring the insider to make full disclosure; and the insider's fiduciary obligations to the closed corporation and its other security holders derived from the principles underlying cases like *Meinhard v. Salmond*[83] may be met by requiring him to obtain the other security holders' informed consent to his transaction or to offer to them an opportunity to participate in it on the same terms as he does. But such remedies are neither entirely adequate nor as readily available to implement insiders' fiduciary duties in the case of publicly-held corporations in readjustment crises.[84]

The cases declining to require insider accountability for dealing in securities of publicly-held corporations[85] tend to rely on premises which are both inapposite to the problems involved and inconsistent with the principles prescribing insider obligations in insolvency liquidation or reorganization and in related contexts. Thus, one general premise on which the cases often purport to rest is that neither the corporation nor its other security holders has

81 136 Kan. 530, 16 P.2d 531 (1932).

82 99 Neb. 509, 156 N.W. 1041 (1916).

83 249 N.Y. 458, 164 N.E. 545 (1928).

84 See notes 66 and 68 *supra*. It may be noted, moreover, that even the selective prescriptions in the case of closed corporations are often enforced either by compelling performance of the duty to inform or invite participation or by requiring accountability for profits when the prescription is not followed. Wabunga Land Co. v. Schwanbeck, 245 Mich. 505, 222 N.W. 707 (1929); Kelly v. 74 & 76 W. Tremont Ave. Corp., 4 Misc. 2d 533, 151 N.Y.S.2d 900 (Sup. Ct. 1956), *modified and aff'd*, 3 App. Div. 2d 821, 160 N.Y.S.2d 932, *aff'd*, 3 N.Y.2d 973 (1957); Glen Allen Mining Co. v. Park Galena Mining Co., 77 Utah 362, 388, 296 Pac. 231, 241 (1931). See also Dutton v. Barnes, 162 Minn. 430, 203 N.W. 414 (1925); and compare Coleman v. Hanger, 210 Ky. 309, 275 S.W. 784 (1925); Young v. Columbia Oil Co., 110 W. Va. 364, 158 S.E. 678 (1931); and Regal v. Gulliver, [1942] 1 All E.R. 378 (H.L.). Compare Note, *Corporate Opportunity*, 74 HARV. L. REV. 765, 772-75 (1961); *but cf.* Stevens v. Hale-Haas Corp., 249 Wis. 205, 23 N.W.2d 620 (1946).

85 Donnelly v. Consolidated Inv. Co., 99 F.2d 185 (1st Cir. 1938); Victor v. Hillebrecht, 405 Ill. 264, 90 N.E.2d 751, *cert. denied*, 339 U.S. 980 (1950). Compare Keely v. Black, 91 N.J. Eq. 520, 111 Atl. 22 (1920); Stanton v. Schenck, 142 Misc. 406, 252 N.Y. Supp. 172 (Sup. Ct. 1931); 140 Misc. 621, 251 N.Y. Supp. 221 (Sup. Ct. 1931).

any vindicable interest in the insider's stock or securities dealings with his purchasers or sellers.[86] This generality ignores the substantial body of cases involving the purchase or sale of securities in possible competition with the corporation[87] as well as the cases dealing with the misconduct of corporate affairs in order to facilitate such purchases or sales.[88] Even when the corporation is not involved in a reorganization crisis or in liquidation, the courts have repeatedly held insiders accountable to the corporation or its security holders solely because, in connection with their efforts to purchase or sell their corporation's securities, they have violated fiduciary obligations they were deemed to have to the corporation,[89] or to its remaining security holders.[90] Hence the question is not whether,

86 See cases cited note 85 *supra*. See also Bisbee v. Midland Linseed Prod. Co., 19 F.2d 24, 27 (8th Cir. 1927); Dupont v. Dupont, 256 Fed. 129 (3d Cir.), *cert. denied*, 250 U.S. 642 (1919); Hauben v. Morris, 255 App. Div. 35, 5 N.Y.S.2d 721 (App. Div. 1938), *aff'd*, 281 N.Y. 652, 22 N.E.2d 482 (1939); Adams v. Mid-West Chevrolet Corp., 198 Okla. 461, 179 P.2d 147 (1947); Stevens v. Hale-Haas Corp., 249 Wis. 205, 23 N.W.2d 620 (1946). Occasionally the cases suggest a different rule for insider trading in stock during an insolvency crisis than they do for insider purchases of debt claims. *E.g.*, Donnelly v. Consolidated Inv. Trust, 99 F.2d 185, 187 (1st Cir. 1935); *In re* Los Angeles Lumber Prod., 46 F. Supp. 77, 90 (S.D. Cal. 1941); Victor v. Hillebrecht, *supra* note 85; Brown v. Cooper, 62 Tenn. 153 (1873); American Bank & Trust Co. v. Lebanon Bank & Trust Co., 28 Tenn. App. 618, 192 S.W.2d 245 (1945); *cf. In re* Midland United Co., 159 F.2d 340, 345 (3d Cir. 1947). On the assumption that the only evil to be reached is competing with the corporation in securing the discharge of its obligations at a discount [*cf.* Manacher v. Central Coal Co., 63 N.Y.S.2d 463, 465 (Sup. Ct. 1946)] insiders have been held free to buy stock during a corporate crisis, since stock, like a *cestui's* interest in a trust, does not represent a claim against the corporation which the trustee is obliged to settle on the best terms. To the extent that the basic assumption is too narrow because the rule of accountability is aimed at more than the mere deprivation of a corporate opportunity, the reasoning of such cases must fall. Moreover, in liquidation and reorganization situations it is not entirely accurate to make the distinction between debt and stock thus suggested. When security holder participations are being rearranged or paid off, all security holders are claimants and the corporation's purchase of some of those claims at a discount might provide extra values for distribution to the remaining claimants of the same or junior classes.

87 See cases cited note 15 *supra*; compare also the qualifying language in, *e.g.*, Bisbee v. Midland Linseed Prod. Co., 19 F.2d 24, 27 (8th Cir. 1927); Dupont v. Dupont, *supra* note 86, at 132-33; Hauben v. Morris, *supra* note 86, 5 N.Y.S.2d, at 730. See also Merger Mines Corp. v. Grismer, 137 F.2d 335 (9th Cir.), *cert. denied*, 320 U.S. 794 (1943).

88 See cases cited note 34 *supra; cf.* Amen v. Black, 234 F.2d 12 (10th Cir.), *cert. granted*, 352 U.S. 888 (1956), *remanded for dismissal by agreement*, 355 U.S. 600 (1958); Seagrave Corp. v. Mount, 212 F.2d 389 (6th Cir. 1954); Zahn v. Transamerica Corp., 162 F.2d 36 (3d Cir. 1947); Lebold v. Inland Steel Co., 125 F.2d 369 (7th Cir. 1941); STEVENS, CORPORATIONS 793-97 (2d ed. 1949).

89 See notes 87 and 88 *supra*.

90 See note 88 *supra*. With respect to the security holders with whom they deal, the existence and character of the insider's fiduciary obligations depend on which of the competing rules applies in a particular jurisdiction. See notes 3 and 33 *supra*. *Compare* Oliver v. Oliver, 118 Ga. 362, 45 S.E. 232 (1903), *with* King Mfg. Co. v. Clay, 216 Ga. 481, 118 S.E.2d 581 (1961).

in the abstract, an insider owes either the corporation or its security holders *any* obligations in connection with his purchases or sales of the corporation's securities. Rather, it is whether the nature of his obligations and of the temptations to abuse them during a corporate crisis justifies a rule designed not merely to vindicate any violation of his obligations but to remove from the insider the temptation to violate them.

It has been argued against extension of such a rule of accountability to insider dealings other than during the pendency of insolvency reorganization that the corporation and its security holders should not be deprived of the benefits they might derive from insider purchases.[91] Thus in *Manufacturers Trust Co. v. Becker*,[92] which declined to extend the rule against insider enforcement at face value of bonds purchased at a discount during bankruptcy to purchases made prior to the initiation of bankruptcy proceedings, the Supreme Court predicated its decision in part on the proposition that the insiders' pre-bankruptcy acquisition of claims against their enterprise at less than seven cents on the dollar may have constituted "reinforcement of the insolvent's position" and "a factor in preventing further financial deterioration of debtor."[93] Similar to that suggestion is the notion that insider purchases during corporate crises may be necessary to enable the insiders to retain control or to eliminate elements hostile or cool to the proposed reorganization or merger or liquidation, or to prevent forced bank-

91 The argument quite obviously does not apply to insider sales or trading. See text at notes 35 and 39-41 *supra*.

92 338 U.S. 304 (1950). The *Becker* case arose under chapter XI, and therefore was not literally within § 212, of the Bankruptcy Act which authorizes courts to hold to cost securities acquired "in contemplation" of a reorganization. Several lower court cases deny enforcement in full of claims purchased at a discount before insolvency proceedings were initiated or when they were not pending. *E.g., In re* Van Sweringen Corp., 119 F.2d 231, 234 (6th Cir. 1941), *cert. denied*, 314 U.S. 671 (1942), time of insider's purchases set out in Gouchenour v. Cleveland Terminals Bldg. Co., 142 F.2d 991, 992 (6th Cir.), *cert. denied*, 323 U.S. 767 (1944); *In re* Franklin Bldg. Co., 83 F. Supp. 263 (D. Wis. 1948), *aff'd*, 178 F.2d 805 (7th Cir. 1949), *cert. denied*, 339 U.S. 978 (1950); *In re* Jersey Materials Co., 50 F. Supp. 428 (D.N.J. 1943); *In re* Los Angeles Lumber Prod. Co., 46 F. Supp. 77 (S.D. Cal. 1941); Bramblet v. Commonwealth Land & Lumber Co., 26 Ky. L. Rep. 1176, 83 S.W. 599 (Ct. App. 1904); *but cf. In re* Philadelphia & W. Ry., 64 F. Supp. 738, 740-41 (E.D. Pa. 1946).

93 338 U.S. at 313; *cf. In re* Nazareth Fairgrounds & Farmers' Mkt., Inc., 296 F.2d 678 (2d Cir. 1961), *cert. granted sub nom.* Wolf v. Weinstein, 369 U.S. 837 (1962). The argument that a stable market may thus be maintained for security holders who wish to sell during the crisis is open to the answer given by the SEC to a similar argument made in support of repeal of § 16(b) of the Exchange Act. See note 49 *supra*.

ruptcy or insure or hasten consummation of a contemplated voluntary readjustment.[94]

But apart from minor nuisance claims, which are de minimis, the so-called hostile or cool interests who are being bought out are likely to represent a substantial investment. They may have extraneous—and unlawful—designs on the enterprise,[95] or they may be seeking the legitimate emoluments of control. But, except in the former case, the holders of such an investment are presumably also interested in either advocating or opposing reorganization, merger or liquidation programs because they think that doing so will protect or improve their investment and that of all other security holders of the same class. There is no reason why, a priori, the insiders' proposals for reorganization or merger or sale of assets must be deemed more advantageous to public security holders than the position taken by so-called hostile interests.[96] Hence, there may be little reason from the public security holders' point of view to encourage the insider to buy out such hostile interests by letting him make a profit on the acquisition. Arguably, in some cases the public security holders might actually be better served if the insider were discouraged from buying out such interests.

However that may be, a rule denying an insider profits on the purchase of securities during such corporate crises does not preclude him from purchasing such securities. If in fact he thinks it necessary, in order to protect his existing position, either to eliminate a nuisance or to buy out a hostile claimant, he is still left free to do so. He is merely deprived of the profits in such a transaction and is treated as if he had loaned to the corporation the money thus used to purchase the hostile claims,[97] a loan for which he may in appropriate cases acquire priority.[98]

94 *Ibid.* Another suggestion, that the insider's purchases may improve public confidence in the credit of the enterprise at a time of crises [see Note, 62 HARV. L. REV. 1391 (1949)], has been contradicted no less authoritatively than it has been asserted. See Comment, 59 YALE L.J. 151, 154-57 (1950).

95 If such improper designs exist, *e.g.*, looting or favoring corporations in which they have interests, appropriate remedies are available to public security holders.

96 *E.g.*, *In re* Franklin Bldg. Co., 178 F.2d 805, 808 (7th Cir. 1949); *In re* Los Angeles Lumber Prod. Co., 46 F. Supp. 77, 82-83 (S.D. Cal. 1941).

97 See *In re* Inland Gas Co., 187 F.2d 813 (6th Cir. 1951); Wing v. Dillingham, 239 Fed. 54 (5th Cir.), *cert. denied*, 244 U.S. 654 (1917); *cf.* Testimony of Thomas G. Corcoran, *Hearings on S. Res. 84, S. Res. 56 and S. Res. 97*, 73d Cong., 1st Sess. 6557 (1934), indicating that in the case of an insider who was forced for extraneous reasons to sell within six months after he purchased "He would get his money out, but the profit goes to the corporation."

98 *Cf.* Sanford Tool Co. v. Brown, 157 U.S. 312 (1895); Bramblet v. Commonwealth

Another principal objection to requiring an insider to account to his corporation and remaining security holders for profits from trading in its securities or otherwise dealing in them during a reorganization is that the seller to (or buyer from) the insider is in fact, if not always in law, likely to be the victim. Because of that, the suggestion is made that it would be improper to allow the corporation (and its remaining security holders) to acquire from the insider the profits which he took unfairly, not from the corporation, but from the persons dealing with him. Indeed the corporation has frequently been held liable to those from whom it has purchased its own securities for precisely the same kind of unfair treatment which the insider may extend to them when he purchases the corporation's securities—failure adequately to disclose information affecting the value of the securities involved.[99]

Certainly neither insiders nor the corporation and its remaining security holders are justified in victimizing those with whom they deal. Arguably, the corporation should not be allowed to purchase its own securities at a discount when a recapitalization or merger or liquidation or the like is contemplated, because of the intrinsic infeasibility of enforcing a rule of full and adequate disclosure to, and fair dealing with, the selling security holders.[100] But even if the interests of public investors should permit the corporation, after as full a disclosure as possible, freely to repurchase its own securities at a discount,[101] it by no means follows that the in-

Land & Lumber Co., 26 Ky. L. Rep. 1176, 83 S.W. 599 (Ct. App. 1904); Chouteau Ins. Co. v. Floyd, 74 Mo. 286, 291 (1881). See also Stuart v. Larson, 298 Fed. 223 (8th Cir. 1924).

99 Mansfield Hardwood Lumber Co. v. Johnson, 263 F.2d 748 (5th Cir.), *cert. denied,* 361 U.S. 885 (1959); Northern Trust Co. v. Essaness Theatres Corp., 103 F. Supp. 954 (N.D. Ill. 1952); Northern Trust Co. v. Essaness Theatres Corp., 348 Ill. App. 134, 108 N.E.2d 493 (1952); Wood v. MacLean Drug Co., 266 Ill. App. 5 (1932); Macgill v. Macgill, 135 Md. 384, 109 Atl. 72 (1919); Ward La France Corp., 13 S.E.C. 373 (1943); 22 SEC ANN. REP. 187-88 (1956); 10 SEC ANN. REP. 176-77 (1944); Comment, 59 YALE L.J. 1120, 1149-54 (1950); Note, 59 HARV. L. REV. 769, 775-78 (1946). *Contra,* Gladstone v. Murray, 314 Mass. 584, 50 N.E.2d 958 (1943). Compare Conant, *Duties of Disclosure of Corporate Insiders Who Purchase Shares,* 46 CORNELL L.Q. 53 (1960).

100 See, *e.g.,* 22 SEC ANN. REP. 187-88 (1956).

101 See Gladstone v. Murray, 314 Mass. 584, 50 N.E.2d 958 (1943); Note, 59 HARV. L. REV. 769, 775-78 (1946). Compare United Gas Corp., 16 S.E.C. 531, 562-64 (1944); *In re* American & Foreign Power Co., 15 S.E.C. 293, 301-04 (1944); Electric Bond & Share Co., 10 S.E.C. 1 (1941); 10 S.E.C. 1206 (1942); 13 S.E.C. 568 (1943); Engineers Pub. Serv. Co., 4 S.E.C. 615 (1939), setting forth a procedure to protect public security holders when corporations repurchase their stock. See also § 23(c) of the Investment Company Act of 1940, 54 Stat. 836, 15 U.S.C. § 80a-23(c) (1958); *but cf.* Martin v. American Potash Co., 33 Del. Ch. 234, 92 A.2d 295 (1952), and Kors v. Carey, 158 A.2d 136 (Del. Ch. 1960).

sider should be entitled to the same freedom in making a purchase for himself. Thus, if a trustee should have purchased a fully informed *cestui's* interest for the trust rather than for himself, or should in any event not have purchased the interest for himself because of a possible conflict of interest with the trust, he will be held accountable to the trust for his personally having made such a purchase.[102] Similarly, to the extent that during a corporate crisis such a conflict exists, the fact that the insider purchased from fully informed security holders should, of course, not preclude him from being accountable to the remaining beneficiaries.

Where the insider, in selling or buying corporate securities, has not made adequate disclosure, there are two types of situations to be considered. On the one hand, the buyer or seller may not be able to identify his transaction as having been consummated with the insider—which is frequently true where sales are made on a securities exchange—or he may fail to pursue his remedy against the insider for a variety of irrelevant reasons, *e.g.*, the cost and time of litigation, difficulties of service of process or of proof, simple inertia, etc., or he may have no remedy.[103] Where the victim thus fails to pursue the wrongdoing insider, there is certainly no reason to relieve the latter of such accounting to the corporation as he would have been required to make if he had dealt fairly with his buyer or seller. That it would have been improper for the corporation to have made the kind of purchase made by the insider does not entitle the insider to keep his ill-gotten gains or deny to the corporation the privilege of receiving them.[104]

On the other hand, the buyer or seller may seek to recover from the insider. In that case, to the extent that the buyer or seller may be identified and can be found, there is no reason to deny him the opportunity to recover.[105] Requiring the insider to account to the

102 RESTATEMENT, AGENCY § 388(c) (1958); RESTATEMENT, RESTITUTION § 200 (1937); RESTATEMENT, TRUSTS §§ 170, comments *j* & *k*, 203, 206, comments *h* & *i* (1959); 2 SCOTT, TRUSTS §§ 203, 206 (2d ed. 1956). Compare L. A. Young Spring & Wire Co. v. Falls, 307 Mich. 69, 102 N.W.2d 329 (1943).

103 See, *e.g.*, Goodwin v. Agassiz, 283 Mass. 358, 186 N.E. 659 (1933). Compare Yourd, *Trading in Securities by Directors, Officers and Stockholders; Section 16 of the Securities Exchange Act*, 38 MICH. L. REV. 133, 148-51 (1939).

104 Where the insider is itself a publicly-owned holding company, its purchase of the subsidiary's securities poses the issue more dramatically, because the contest is in effect between public security holders of the subsidiary and the security holders of the parent [*cf. In re* Electric Power & Light Co., 176 F.2d 687, 692 (2d Cir. 1949)] but requires no different resolution of the question.

105 Bond & Mortgage Guar. Co., 303 N.Y. 423, 103 N.E. 721 (1952); see BALLANTINE,

corporation need not deny the victim the right to recover. On prevailing in any such litigation against the insider, or indeed, on consent of the insider in a settlement with the victim, the corporation to which the insider has turned over his profit can be required to pay the victim's claim to the extent of such profit.[106] But to the extent that the insider's profit exceeds the damage to the selling security holder, or in the absence of a claimant to establish that he is wronged, there is no reason to permit the insider to keep profits which by assumption were obtained from improper dealings with third persons.[107] Such is the conclusion reached by Congress and the courts in insolvency situations. It is difficult to see why any different conclusion is required where the corporate liquidation or reorganization crisis is the product of considerations other than insolvency.

V. PERIPHERAL CONSIDERATIONS

An attack on insider dealings in his corporation's securities[108] during corporate readjustment crises which strikes at conduct that is not merely identifiably wrongful or injurious, but which may well be innocent, argues for a sanction no more punitive than the traditional requirement of accountability for profits. This is not to deny that if in any particular case there is wrongful behavior or proven damage, a more substantial liability may be posited.[109]

CORPORATIONS 216-17 (rev. ed. 1946); STEVENS, CORPORATIONS 701-02 (rev. ed. 1949); compare Leech, *supra* note 59, at 826-30.

106 It has been suggested that the action on behalf of the corporation be stayed while the rights of those who dealt with the insider are determined. See note 105 *supra*. Presumably this would require efforts to be made, at the corporation's initial expense, to ascertain the identity of such persons and inform them of their rights.

107 It has also been suggested that the insider should be both accountable to his corporation and liable to the victimized seller. See 2 LOSS, SECURITIES REGULATION 1173-74 (2d ed. 1961); Yourd, *supra* note 103, at 149 n.56; Comment, 59 YALE L.J. 1120, 1141-42 (1950). To the extent that accountability for profits is required even though the corporation is not injured, it is difficult to see why, if the insider has no profits because he has compensated his victimized seller, the corporation should nevertheless recover the quondam profits. *Cf.* Hennessey v. Fein, 184 F. Supp. 86 (S.D.N.Y. 1958).

108 The considerations governing limitations on dealings in their own corporations' securities suggest that pending mergers or acquisitions, insiders of all participating enterprises which are materially affected by such mergers or acquisitions should be precluded from dealing in securities of any of the participants, not merely of their own enterprise. *Compare* Regal v. Gulliver, [1942] 1 All E.R. 378 (H.L.), *with* Kaufman v. Wolfson, 153 F. Supp. 253 (S.D.N.Y. 1957).

109 The distinction between a culpable breach of trust and mere divided loyalty [See Niles, *Trustee Accountability in the Absence of Breach of Trust*, 60 COLUM. L. REV. 141 (1960)] has not been rigorously observed in this area, as is apparent from the judicial and legislative imposition of the sanction of denial of compensation upon

Application of the rule of accountability for insiders' profits to dealings in contemplation of, or during the pendency of, voluntary reorganization or change-of-business crises, in contrast to the extension of the rule of section 16(b) to trading in the over-the-counter market,[110] is not, as a matter of either history or policy, dependent upon legislative authority. Regulation of the conduct of corporate insiders in their relationship with their corporation and its security holders is historically part of the business of courts of equity. Those courts initiated the requirement of accountability for profits from insiders' dealings in claims against their corporations in the context of insolvency long before legislation on the subject was contemplated or enacted. They can apply the principle with equal facility to an insider's dealings in any kind of security of his corporation in the context of corporate crises created other than by insolvency. Indeed, congressional action in the insolvency area and SEC action in utility holding company reorganizations may fairly be said to reflect a public policy to which the judiciary should give particular heed in developing rules in a field which is a traditional domain of courts of equity.[111]

fiduciaries who buy or sell securities during insolvency reorganization—on the ground that such transactions constitute a breach of trust, as a result of which the trustee should be denied compensation. See *In re* Republic Gas Corp., 35 F. Supp. 300, 303 (S.D.N.Y. 1936); Testimony of Securities and Exchange Commissioner William O. Douglas, *Hearings Before House Committee on the Judiciary, on H.R. 6439, Subsequently Amended and Reintroduced as H.R. 8046*, 75th Cong., 1st Sess. 184 (1937). On the other hand, such a distinction appears to be involved in the decision of the court of appeals in *In re* Nazareth Fairgrounds & Farmers' Mkt., Inc., 296 F.2d 678 (2d Cir. 1961), *cert. granted sub nom.* Wolf v. Weinstein, 369 U.S. 837 (1962), although the formal issue in the case was whether an officer and a supervisory employee are persons who act "in a representative or fiduciary capacity" within the meaning of § 249 of the Bankruptcy Act. While the court concluded that they were not acting in a fiduciary capacity for purposes of § 249, it recognized that such persons owed fiduciary obligations to the corporation which extended to their dealing in its securities. To the extent that the court's opinion can be read to suggest only selective accountability for profits from such transactions, it is at odds with the rigorous rule of accountability embodied in earlier decisions. See notes 10-12 *supra*.

110 A rule thus designed to prescribe conduct in organized security markets straddling many states is appropriately a matter for national rather than local interest; and to the extent that such a rule is a command of the substantive law, and effective enforcement of such a rule rests heavily on the availability of published reports of insider trading, the problem requires legislative solution. In any event, the long history of unsuccessful efforts to obtain such legislation [See 2 Loss, *op. cit. supra* note 107, at 1152-65], including the current investigation being conducted by the SEC, may well justify, if not require, judicial reluctance to act without implementing legislation.

111 See Stone, *The Common Law in the United States*, 50 HARV. L. REV. 4, 12-16 (1936), and compare SEC PROTECTIVE COMMITTEE STUDY, pt. VIII, at 231 (1937): "The judicial rule, as bearing on bankruptcy reorganizations, is now embodied in Chapter X

To be sure, there may be problems in applying the prophylactic principle in particular cases or in delineating all the kinds of corporate crises in which the principle should govern insiders' behavior. Thus, not every formal merger or acquisition may constitute so fundamental a change in the business or structure of both the corporate parties to it so as to require invoking the principle for all of the insiders involved.[112] Nor can a corporation whose assets have been sold be said to be equally in a state of crisis when it has reinvested 80 percent of the proceeds as it is when it has not reinvested any of the proceeds or when it has reinvested only 20 percent of the proceeds. Similarly, recapitalization or merger or liquidation of an enterprise may have been in contemplation or the subject of negotiations to a greater or lesser extent, or predictable with varying degrees of probability, for long periods of time or on many previous occasions before actual consummation; and in any given case it may be difficult to determine whether it was sufficiently imminent to justify application of the prophylactic principle to the insider transactions involved.[113] No less difficult problems may arise in prescribing the remedy for insider transactions in violation of the principle during a conceded corporate crisis. Thus, when only the insider's purchase or sale occurs during, or in anticipation of, the crisis, questions may exist as to how to make the insider account for the unrealized portion of the profit or for only the realized portion which may be attributable to the crisis.

But courts exercising equity jurisdiction lack neither the power nor the ingenuity to determine when a merger or liquidation may reasonably be said to be in contemplation or otherwise to define the contours of the corporate crises to which the rule should apply.[114] Nor are they powerless to fashion appropriate

of the Act. But other areas of reorganization remain unaffected, except as they may be embraced by further judicial adoption of the fiduciary principles."

112 *E.g.*, merger into, or acquisition by, the Ford Motor Company of a small supplier of parts may constitute a fundamental transition for the latter (and thus require its insiders and possibly Ford's insiders to refrain from dealing in its stock) but not for Ford.

113 In this connection, it may be noted that during prolonged insolvency reorganizations comparable negotiations may occur and lapse many times, but the prophylactic rules of chapter X of the Bankruptcy Act and of related cases govern insiders' securities transactions during the entire reorganization.

114 In Manufacturers Trust Co. v. Becker, 338 U.S. 304 (1950), the Court left ajar, if not open, the question whether pre-bankruptcy purchases of claims made when liquidation was plainly imminent or with a view to affecting the initiation or re-

remedies for insider dealing on each such occasion.[115] If, on the merits, the prophylactic principle should otherwise be invoked for the protection of public investors during the pendency of mergers or change-of-business crises, the problem of defining the outer limits of the principle's applicability or of prescribing a remedy for the occasional difficult case should not preclude judicial application of that principle. And the historic ability of courts of equity jurisdiction to cut the suit to fit the cloth suggests that the judicial process may be more appropriate than legislation for thus adapting the principle to new contexts.

organization proceedings would result in fully enforceable claims (338 U.S. at 315), a question with which it may be noted the SEC has wrestled inconclusively under the Holding Company Act. See Middle W. Corp., 27 S.E.C. 195, 224-25 (1947); Cities Serv. Corp., 26 S.E.C. 678, 694-95 (1947). The problem is whether to delineate the tainted pre-reorganization period by some absolute standard—such as the six-month period which § 16(b) of the Exchange Act offers—or to let a more selective and possibly subjective standard—such as whether the insider knew or reasonably should have known that a merger, recapitalization or liquidation was sought or would soon have to be carried out—test the propriety of the transactions. To the extent that compliance with the latter standard will be determined by inference from the proximity of the insider's transactions to the initiation or reorganization or merger negotiations or the like, it will, of course, approach the absolute standard.

115 Thus, if the insider acquired securities long before a merger or recapitalization was considered, and they have increased in value over the years, the fact that he sells them during the pendency of merger negotiations or immediately preceding the recapitalization need not deny him the increment in value up to the time the merger or recapitalization became a realistic possibility. His accountability would be only for the portion of the profits generated in anticipation of the merger or recapitalization. Compare rule 16(b)-6 under the Securities Exchange Act of 1934, 48 Stat. 896, 15 U.S.C. § 78p(b) (1958). Similarly, if the insider purchases securities at a discount after a sale of assets and while the corporation is looking for a new business, the fact that he does not sell the securities after the corporation acquires the new business need not preclude accountability for the amount of the discount. It is not foreign to courts of equity to require that securities be turned in to the corporation at cost, or if this is impracticable or not feasible, that the insider be required to account as if he had profited by at least the amount of the discount. Compare, *e.g.*, Amen v. Black, 234 F.2d 12 (10th Cir.), *cert. granted*, 352 U.S. 889 (1956), *remanded for dismissal by agreement*, 355 U.S. 600 (1958); Berner v. Equitable Office Bldg., 175 F.2d 218, 222 (2d Cir. 1949); Ashman v. Miller, 101 F.2d 85 (6th Cir. 1939); Electric Power & Light Co., 33 S.E.C. 348, 355-59 (1952).