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Corporations - Securities: Regulation - Parent Corporation as Insider Realizing Shortswing Profit

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CORPORATIONS—SECURITIES REGULATION—PARENT CORPORATION AS INSIDER REALIZING SHORTSWING PROFIT—Parent corporation, owning a majority of the outstanding voting securities of its subsidiary, sold 120,000 shares of the subsidiary's common stock. A substantial shortswing profit was realized on 4115 shares which had been purchased on the open market five months earlier.[1] The sale, whereby the parent was to divest itself of control of its subsidiary, was made pursuant to an agreement between both companies and approved by a majority of the voting stock of each. Section 16 (b) of the Securities Exchange Act of 1934[2] provides that officers, directors and beneficial owners of more than ten percent of any class of equity securities shall be liable to the issuing corporation for any profit realized from the sale of its securities held for less than six months. Plaintiff brought a shareholder derivative action on behalf of the subsidiary against the parent under section 16 (b). On appeal from a judgment in favor of plaintiff, *held,* affirmed. The agreement between parent and subsidiary which induced the sale does not prevent recovery for the benefit of the subsidiary under section 16 (b). The clear language and purpose of the statute precludes an estoppel based upon instigation by or benefit to the subsidiary. *Magida v. Continental Can Company,* (2d Cir. 1956) 231 F. (2d) 843.

At common law the majority rule is that no fiduciary duty exists between a director or officer and the individual shareholder of a corporation with respect to the stock of the corporation.[3] Thus, a director or officer is under no legal compulsion to disclose any "inside" information to individual shareholders when dealing in equity securities of a corporation.[4] Section 16 (b) was designed to minimize the use of inside information by persons who stand in such relation to the corporation that they are likely to have access to special information.[5] The difficulties inherent in proving the actual use of inside information[6] and the impossible task in most cases

[1] In May 1950 the parent owned approximately 51.9% of the subsidiary's outstanding preferred stock and approximately 59.2% of its common stock. The parent sold all the preferred stock to the subsidiary. The sale of 120,000 shares of common stock reduced the parent's holding to about 20% of the entire issue of common stock.

[2] 48 Stat. 896 (1934), 15 U.S.C. (1952) §78p (b).

[3] Walsh v. Goulden, 130 Mich. 531, 90 N.W. 406 (1902); Carpenter v. Danforth, 52 Barb. (N.Y.) 581 (1868); Seitz v. Frey, 152 Minn. 170, 188 N.W. 266 (1922). *Contra,* Oliver v. Oliver, 118 Ga. 362, 45 S.E. 232 (1903). See generally 84 A.L.R. 615 (1933).

[4] Legal writers are vigorously opposed to the rule. For an extensive compilation of articles see Yourd, "Trading in Securities by Directors, Officers and Stockholders: Section 16 of the Securities Exchange Act," 38 MICH. L. REV. 133, n. 31 (1939).

[5] Commissioner of Internal Revenue v. Obear-Nester Glass Co., (7th Cir. 1955) 217 F. (2d) 56, cert. den. 348 U.S. 982 (1955), reh. den. 349 U.S. 948 (1955); Truncale v. Blumberg, (S.D. N.Y. 1948) 80 F. Supp. 387; Stella v. Graham-Paige Motors Corp., (S.D. N.Y. 1952) 104 F. Supp. 957.

[6] See the testimony of Thomas G. Corcoran, chief spokesman for the draftsmen of the act in S. Hearings before the Committee on Banking and Currency on S. Res. 84, 72d Cong., 2d sess., and S. Res. 56, S. Res. 97, 73d Cong., 1st and 2d sess., p. 6557 (1934).

of ascertaining who actually suffered the loss, led the framers of section 16 (b) to provide absolute liability to the company for all shortswing profits irrespective of the intent of the insider.[7] In the principal case, these absolute rules combine to produce some outward inequities and perhaps demonstrate some real limitations. The primary contention of the parent was that it would be inequitable to allow a suit on behalf of the subsidiary in view of the fact that the subsidiary had instigated the plan of sale and had materially benefited from its operation. The rejection of this defense appears to be justified in light of the objective sought to be accomplished by the statute. Section 16 (b) was not designed to compensate the issuer corporation. Recovery by the issuer is provided only as a practical expedient.[8] The sole objective of the statute is to remove the incentive to make shortswing profits by removing the profits.[9] Therefore, the fact that the shortswing sale produces a benefit to the issuer or its shareholders is immaterial.[10] Furthermore, rejection of the estoppel doctrine seems justified since in most instances the parent-insider can dictate the policies of the subsidiary and, in all cases, can provide majority shareholder approval of any plan or policy decision. Although it may be argued that section 16 (b) was not designed to deter shortswing sales by a parent of its subsidiary's securities, the clear language and purpose of section 16 (b) admit no such exception. It may be questioned, however, whether or not the primary objective of the statute to provide a strong deterrent to the use of inside information is realized in the parent-insider situation. The recovery by the subsidiary will necessarily be reflected in an increase in the value of the equitable interest of the parent, and although this is undoubtedly not as desirable as a cash profit it is perhaps more appealing than not using inside information to any advantage whatsoever.[11] When, as in the principal case the shortswing transaction itself operates to reduce the insider's equitable interest to relatively low levels, the full impact of the statute is felt, but as a

[7] Smolowe v. Delendo Corp., (S.D.N.Y. 1942) 46 F. Supp. 758, affd. (2d Cir. 1943) 136 F. (2d) 231, cert. den. 320 U.S 751 (1943); Gratz v. Claughton, (2d Cir. 1951) 187 F. (2d) 46, cert. den. 341 U.S. 920 (1951).

[8] Commissioner of Internal Revenue v. Obear-Nester Glass Co., note 5 supra.

[9] Smolowe v. Delendo Corp., note 7 supra; Commissioner of Internal Revenue v. Obear-Nester Glass Co., note 5 supra. The original bill provided for criminal sanctions in addition to the civil recovery. See testimony of Thomas G. Corcoran in S. Hearings before the Committee on Banking and Currency on S. Res. 84, 72d Cong., 2d sess., and S. Res. 56 and S. Res. 97, 73d Cong., 1st and 2d sess., pp. 6556, 6557 (1934).

[10] In this regard, §29 (a) of the act, 48 Stat. 903 (1934), 15 U.S.C. (1952) §78cc (a) provides: "Any condition, stipulation or provision binding any person to waive compliance with any provision of this title or of any rule or regulation thereunder . . . shall be void." This section would seem to eliminate a defense based on estoppel. Cf. Jefferson Lake Sulphur Co. v. Walet, (E.D. La. 1952) 104 F. Supp. 20, affd. (5th Cir. 1953) 202 F. (2d) 433, cert. den. 346 U.S. 820 (1953); Park & Tilford v. Schulte, (2d Cir. 1947) 160 F. (2d) 984, cert. den. 332 U.S. 761 (1947). Cf. Consolidated Engineering Corp. v. Nesbit, (S.D. Cal. 1951) 102 F. Supp. 112.

[11] This limitation on the deterrent effect of the statute is present even at low percentages of insider ownership, but the greater the equitable interest, the less will be the real loss sustained by the insider by virtue of the profit recovery accruing to the issuer.

general proposition large holders of equity securities who remain so after a shortswing profit have relatively little to lose by operation of the statute. The existence of this limitation is, of course, not a justification for allowing the parent-insider to retain shortswing profits, thereby eliminating all deterrent effect, but it is perhaps indicative of a need for revision in the recovery feature of the statute.

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