Michigan Law Review

Volume 53 | Issue 5

1955

Corporations - Reclassification of Securities as a Purchase Under Section 16 (B) of the Securities and Exchange Act

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CORPORATIONS—RECLASSIFICATION OF SECURITIES AS A PURCHASE UNDER SECTION 16(B) OF THE SECURITIES AND EXCHANGE ACT—Plaintiff, a minority stockholder in the Old Town Corporation, brought action on behalf of the corporation to recover alleged "shortswing" profits made by defendants, who were officers, directors and large shareholders of Old Town, on the sale of 45.9 percent of the outstanding stock of the corporation. The corporation had, with the approval of 78 percent of the owners in interest, reclassified the 320,402 outstanding shares of $5 par common stock as 320,402 shares of $1 par common and 320,402 shares of 40¢ cumulative preferred stock of $7 par value. This reclassification was done for the frank purpose of increasing the market value and salability of defendants' interest so that the defendants could sell their holdings. Within six months of the reclassification defendants sold both the new common stock and the preferred stock. *Held*, the reclassification was not a purchase so as to bring it within the scope of section 16(b) of the Securities and Exchange

Act of 1934.[1] *Roberts v. Eaton,* (2d Cir. 1954) 212 F. (2d) 82, cert. den. 348 U.S. 827, 75 S.Ct. 44 (1954).

Section 16(b) permits recovery by the issuer, or by any stockholder if the corporation refuses to take action, of the profits made by an insider from any "purchase and sale, or any sale and purchase . . . of such issuer . . . within any period of less than six months. . . ."[2] A purchase is "any contract to buy, purchase or otherwise acquire. . . ."[3] An "insider" under the act is an officer, director or direct or indirect beneficial owner of more than ten percent of any equity security of a listed corporation.[4] Section 16(b) has been consistently interpreted according to the purpose of the act rather than its literal implication. The purpose is to protect the "outside" stockholders from any possible detrimental use of the superior position of the "insiders."[5] The principal case appears to set three requirements for the "immunization" of a transaction resulting in the acquisition of securities: (1) no change in the total ownership interest of the stockholder, (2) no possibility of abuse of inside information, and (3) no option on the part of the individual stockholder to refuse the new securities. The court did not find any change in interest in the extinction of the old common and the issuance of the two new series of stock.[6] It also distinguished the principal case from previous cases[7] in which the acquired securities were of a pre-existing class, were publicly held, and had an independent value in a pre-existing market. The only other instance of a change in the form of proprietary interest to be held not a purchase or sale occurred where an exchange of shares with a wholly owned subsidiary was held to be a mere transfer from one corporate pocket to another.[8] This requirement of a change in substance as well as form seems to settle a question raised by dictum in *Park & Tilford v. Schulte,*[9] where it was said that there had been a purchase because "defendants did not own the common stock before they exercised their option to convert; they did afterward."[10] In the principal case, *Park & Tilford* was distinguished as resting upon the voluntary actions of that defendant in converting his preferred stock for common. The court found no such option to be present in this case since the corporation

[1] 48 Stat. L. 896 (1934), 15 U.S.C. (1952) §78p(b).

[2] Ibid.

[3] 48 Stat. L. 884 (1934), 15 U.S.C. (1952) §78c(13).

[4] 48 Stat. L. 896 (1934), 15 U.S.C. (1952) §78p(a).

[5] Smolowe v. Delendo Corp., (2d Cir. 1943) 136 F. (2d) 231, cert. den. 320 U.S. 751, 64 S.Ct. 56 (1943); Shaw v. Dreyfus, (2d Cir. 1949) 172 F. (2d) 140, cert. den. 337 U.S. 907, 69 S.Ct. 1048 (1949); Loss, SECURITIES REGULATION 564 (1951).

[6] ". . . any change in value due to the split or reclassification of stock comes substantially from the actual or expected tastes and preferences of the public for particular types and forms of securities; and values due to company prospects or plans will be reflected in the ordinary market value of the original stock." Principal case at 85.

[7] Park & Tilford, Inc. v. Schulte, (2d Cir. 1947) 160 F. (2d) 984, cert. den. 332 U.S. 761, 68 S.Ct. 64 (1947); Blau v. Hodgkinson, (D.C. N.Y. 1951) 100 F. Supp. 361; Truncale v. Blumberg, (D.C. N.Y. 1948) 80 F. Supp. 387; Blau v. Mission Corp., (2d Cir. 1954) 212 F. (2d) 77, cert. den. 347 U.S. 1016, 74 S.Ct. 872 (1954).

[8] Blau v. Mission Corp., note 7 supra.

[9] (2d Cir. 1947) 160 F. (2d) 984, cert. den. 332 U.S. 761, 68 S.Ct. 64 (1947).

[10] 160 F. (2d) 984 at 987.

had effected a statutory reclassification and there was no provision for minority stockholders to accept cash for their old holdings. It was not regarded as significant that effective control, though not an absolute majority control, was in the hands of defendants and that they had, therefore, a real choice in the matter.[11] Nor was it deemed determinative that the reclassification was made for the benefit of the individual defendants rather than the corporation. In giving what appears to be undue emphasis to the corporate fiction, the holding of the court may be open to attack on three grounds. First, the individual stockholder's rights as owner of a share of preferred and a share of $1 common are not the same as they were when he held only the $5 common. As the owner of both types he is in a position to alienate completely certain of his interests in the corporation, while retaining the rest, or he could sell both issues to separate parties for a higher total sale price than he could have received for the sale of the old $5 common.[12] Secondly, the advance knowledge of the future actions of a corporation in regard to its stock gives rise to the possibility of just those abuses which the act was designed to stop. In the principal case there is no serious contention of abusive use of the information, but because the defendants by their position as directors, officers and large stockholders did know in advance of, and in fact initiated, the reclassification, they did have that opportunity.[13] Finally, even if it is valid to distinguish cases on the basis of an option on the part of the stockholder to take the new security which he has received or is about to receive, nevertheless it should not be applied to cases where the insider has such effective control over the issuer that his decision is in effect the corporate decision.

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[11] Compare Park & Tilford, note 7 supra, at 988 with Shaw v. Dreyfus, note 5 supra. Note also Judge Clark's dissenting opinion in the latter case.

[12] Cf. note 6 supra.

[13] See the dissent in Shaw v. Dreyfus, note 5 supra. Worth noting is the fact that a reclassification might be deemed a sale though not a purchase. Had the defendants in the principal case, knowing that the change in the capital structure would give rise to a permanent increase in the market value of the security involved, purchased additional outstanding stock before this information was made public and within six months prior to the reclassification, the result might well have been different.