

1950

## CORPORATIONS-MEASURE OF SHORT SWING PROFITS UNDER SECTION 16(b) OF THE SECURITIES EXCHANGE ACT OF 1934

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### Recommended Citation

G. B. Myers S.Ed., *CORPORATIONS-MEASURE OF SHORT SWING PROFITS UNDER SECTION 16(b) OF THE SECURITIES EXCHANGE ACT OF 1934*, 49 MICH. L. REV. 273 ().

Available at: <https://repository.law.umich.edu/mlr/vol49/iss2/11>

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CORPORATIONS—MEASURE OF SHORT SWING PROFITS UNDER SECTION 16(b) OF THE SECURITIES EXCHANGE ACT OF 1934—Plaintiff, a stockholder in X corporation, sued in the name of and on behalf of the corporation to recover short swing profits made by defendants in the sale of stock purchase warrants of the

corporation, in violation of the Securities Exchange Act.<sup>1</sup> Defendants were officers of the corporation and as part of the consideration for entering into their contracts of employment they received each year a number of these warrants.<sup>2</sup> Within six months of the receipt of their 1945 warrants defendants had made certain sales of warrants then held by them. The court, in a previous ruling,<sup>3</sup> had granted a motion by plaintiff for a summary judgment holding that the warrant transactions violated section 16(b) of the Securities Exchange Act of 1934, but the question as to the amount of profits realized from the transactions was set over for trial. The trial developed no serious issues of fact but presented a question of law as to the measure of "profits" to be employed in this case. Plaintiff argued that inasmuch as the warrants had a cost of zero to defendants the profits realized amounted to the entire sale price.<sup>4</sup> Defendants, on the other hand, contended that the cost of the warrants was to be found in the execution of the original employment contracts. On argument to the court, *held*, for defendants. The measure of profits is the difference between the market value of the warrants at the time of acquisition and the market value at the time of sale. *Truncate v. Blumberg*, (D.C. N.Y. 1950) 88 F. Supp. 677.

At common law there was no remedy against "insiders," for market speculation in the securities of the corporation.<sup>5</sup> The declared purpose of section 16(b) of the statute is to prevent the use of inside information to obtain an unfair advantage in the market.<sup>6</sup> To carry out this purpose the courts have sought to take all possible profit out of transactions in violation of the act.<sup>7</sup> Though the cases are few, the term "profits" has been defined before. In a case where numerous sales and purchases had taken place the profit was measured by the difference between the "lowest price in" and the "highest price out."<sup>8</sup> When preferred shares were converted to common and sold, the measure for the single transac-

1 ". . . any profit realized by him . . . shall inure to and be recoverable by the issuer. . . ." 48 Stat. 881 (1934), 15 U.S.C.A. (1941) §78p(b). Held constitutional in *Smolowe v. Delendo Corp.*, (2d Cir. 1943) 136 F. (2d) 231, cert. den. 320 U.S. 751, 64 S.Ct. 56 (1943); 148 A.L.R. 300 (1944). Substantially the same language was used in the Public Utility Company Holding Act of 1935. 49 Stat. 803 (1935), 15 U.S.C.A. (1941) §79q(b).

2 For additional information on this case see the opinions (D.C. N.Y. 1948) 80 F. Supp. 387 and (D.C. N.Y. 1949) 83 F. Supp. 628.

3 (D.C. N.Y. 1948) 8 F.R.D. 492.

4 This was probably the tax procedure recommended by the Bureau of Internal Revenue. See IT 3795, 1946-1 Cum. Bul., p. 15.

5 3 FLETCHER, *CYC. CORP.*, perm. ed., §§1168 and 1171 (1947) outlines the few limitations which existed with respect to the market operations of officers and directors. See generally, Yourd, "Trading in Securities by Directors, Officers and Stockholders: Section 16 of the Securities Exchange Act," 38 *MICH. L. REV.* 133 (1939). See also *Strong v. Repide*, 213 U.S. 419, 29 S.Ct. 521 (1909).

6 "For the purpose of preventing the unfair use of information which may have been obtained . . . by reason of his relationship to the issuer. . . ." 15 U.S.C.A. (1941) §78p(b).

7 *Smolowe v. Delendo Corp.*, supra note 1; *Park and Tilford v. Schulte*, (2d Cir. 1947) 160 F. (2d) 984. But see *Shaw v. Dreyfus*, (2d Cir. 1949) 172 F. (2d) 140; *Truncate v. Blumberg*, opinion at 80 F. Supp. 387, noted critically for its tax avoidance possibilities in 62 *HARV. L. REV.* 706 (1949).

8 *Smolowe v. Delendo Corp.*, supra note 1.

tion was the difference between the market value of the preferred at the time of the conversion and the market value of the common at the time of the sale.<sup>9</sup> It is clear, in the principal case, that there is no rational analogy between "profits" under the tax statutes, and the "profits" which the Securities Act seeks to reach. The former are concerned with economic gain in general, the latter reaches only that gain which results from prima facie misuse of inside information.<sup>10</sup> The cost of these warrants is certainly to be found in the rights and obligations of the original employment contract. The warrants were undoubtedly part of the inducement which attracted defendants from their previous employment to a speculative venture.<sup>11</sup> Of course an exact monetary value cannot be fixed for such an intangible commodity, and therefore the court has adopted the most logical alternative. The decision of the principal case adds some sound interpretation to this section of the statute.

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<sup>9</sup> *Park and Tilford v. Schulte*, supra note 7; *Arbetman v. Playford*, (D.C. N.Y. 1949) 83 F. Supp. 335.

<sup>10</sup> Cf. the philosophy discussed in *MAGILL, TAXABLE INCOME*, rev. ed., c. 5 (1945) with that set out in *Smolowe v. Delendo Corp.*, supra note 1. It is interesting to note that had plaintiff's argument been successful, defendants would have been forced to hold all the warrants, or the stock purchased by their exercise, until the end of their employment, for any sale by them at any time would have come within the statute, and the corporation would then be entitled to the entire proceeds.

<sup>11</sup> Principal case at 679.