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CORPORATIONS-SECURITIES EXCHANGE ACT OF 1934--MEASURE OF SHORTSWING PROFITS UNDER SECTION 16(b)

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CORPORATIONS—SECURITIES EXCHANGE ACT OF 1934—MEASURE OF SHORT-SWING PROFITS UNDER SECTION 16(b)—Plaintiff stockholder brought a derivative action against the defendant officer for profits made in violation of section 16(b) of the Securities Exchange Act of 1934[1] on the purchase and sale, within six months, of securities issued by the corporation under an "incentive" option agreement. The contract provided that on or after the first accrual date, until a fixed termination date, a stated number of shares could be purchased at a set price; the same privilege accrued with the identical termination date in each of the next two years. There was no dispute of fact; the question thus centered on the computation of short-swing profits. The defendant argued that the proper cost-base should be the market price at the date of acquisition. This was the date of the highest priced sales by the defendant, and its use would have resulted in no profit as to the stock then acquired. The argument was based on a decision of the same court made eleven months earlier holding the cost-base to be the date of acquisition of warrants issued yearly during an employment contract.[2] On motion for summary judgment, *held,* the proper cost-base was the market price on the date that the option accrued. The first case in which the acquisition date was fixed by the contract is distinguishable on its facts from the case at bar in that the officer here had the choice of exercise dates.[3] *Steinberg v. Sharpe,* (D.C. N.Y. 1950) 95 F. Supp. 32.

In the previous case the date of issuance of the warrants at the end of each year was, in effect, the date of both the acquisition and accrual of the rights. The

[1] "For the purpose of preventing unfair use of information which may have been obtained . . . by reason of his relationship to the issuer, any profit realized by him . . . within any period of less than six months . . . shall inure to and be recoverable by the issuer. . . ." 48 Stat. L. 881 (1934), 15 U.S.C.A. (1941) §78p(b).

[2] This standard was suggested in the dissenting opinion of Clark, Cir. J., Shaw v. Dreyfus, (2d Cir. 1949) 172 F. (2d) 140 at 143; and was adopted in Truncale v. Blumberg, (D.C. N.Y. 1950) 88 F. Supp. 677, noted in 49 MICH. L. REV. 273 (1950). A similar result was reached in the conversion of preferred into common stock, Park & Tilford v. Schulte, (2d Cir. 1947) 160 F. (2d) 984.

[3] Principal case at 33.

court had analogized such warrant issues to a payment of equal compensation in cash.[4] In the instant case, the accrual dates, fixed when the contract was entered into, are thought controlling, for they more closely parallel the hypothetical payment dates than the date of acquiring the securities, and are free from the subjective market considerations that an officer might weigh in choosing his moment of exercise. Under the old rule, it is asserted, the officer could undermine the purposes[5] and circumvent the penalties[6] of section 16(b) by delaying exercise of the options until the market had reached the high point he desired, then exercise and sell. If the exercise price equaled the sales price, there would be no profit under the act, although the officer had accomplished the speculation which the section was designed to prohibit. At the very least, under the "lowest price in, highest price out" rule,[7] the officer is given an opportunity to weigh market factors in an attempt to reach a high subtrahend. Implicit in the court's thinking is the reasoning that a short-swing in the market would not likely be a reflection of the defendant's efforts as officer. Therefore he should not be given the benefit of using his "inside" knowledge to reduce or eliminate his liability by choosing the date which will determine cost. However, any long term upward trend may be assumed to be due in part to the officer's endeavor,[8] and such increased value should be allowed without liability as an increment of his salary in accordance with the employment agreement. The court, by looking to the contract accrual dates, fixed by the parties at the time the agreement is entered into, achieves a more objective cost-base standard, while the defendant is denied a liability avoidance device which subverts the purposes of section 16(b).

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[4] "The effect of such measurement is to treat the transaction as if, on December 12, 1945, the corporation had paid to defendants an amount of money sufficient to purchase such warrants and defendants had thereupon made the purchase." Truncale v. Blumberg, supra note 2, at 679.

[5] ". . . §16(b), specifically, was designed to protect the 'outside' stockholders against at least short-swing speculation by insiders with advance information." Smolowe v. Delando Corp., (2d Cir. 1943) 136 F. (2d) 231 at 235, cert. den. 320 U.S. 751, 64 S.Ct. 56 (1943). Section 16(b) is discussed in 95 UNIV. PA. L. REV. 468 (1947).

[6] The matching of purchases and sales within six months is done arbitrarily to produce a maximum profit. The rationale and constitutionality of this "lowest price in, highest price out" rule is discussed in Smolowe v. Delando Corp., supra note 5, and Gratz v. Claughton, (2d Cir. 1951) 187 F. (2d) 46.

[7] See note 6 supra.

[8] Employee distinguished from officer in Colby v. Klune, (2d Cir. 1949) 178 F. (2d) 872.