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## Corporations -- Section 16(b) Liability -- Conversion Transactions by Insiders

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reasonable if the court had held that the acquisition and transfer of the 25,942 shares were a "purchase" and "sale" by Gamble-Skogmo which resulted in a technical violation of the statute.<sup>34</sup> But, since no profit was realized on the transaction, there was nothing the plaintiff could recover. Again, the only recoverable profit would be on the 6,058 shares that were retained by Gamble-Skogmo and later sold.

It is unfortunate that both of the courts in *Gamble-Skogmo* failed to express clearly their concept of the trust fund's relationship to the corporation. Nevertheless, whether the trust fund be considered separate from or part of the corporation, there seemingly was no "profit realized" by Gamble-Skogmo on the 25,942 trust fund shares. Therefore, it is submitted that a correct application of the statute in this case should have allowed plaintiff to recover only the profit made on the 6,058 shares actually involved in the short-swing transaction.

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#### Corporations—Section 16(b) Liability—Conversion Transactions by Insiders

In *Heli-Coil Corp. v. Webster*,<sup>1</sup> the United States Court of Appeals for the Third Circuit has taken a novel approach to certain questions concerning liability under the Securities Exchange Act of 1934.<sup>2</sup> Defendant Webster, a director of Heli-Coil Corporation, purchased a quantity of the corporation's callable debentures, which were convertible into common stock any time before redemption or maturity. Within six months of the purchase of the debentures, Webster converted, exchanging the bonds for 3,600 shares of common stock, and within six months of conversion, he sold 1,300 shares of the Heli-Coil common. There had been no call on the debentures. The corporation brought suit to recover short-swing profits under the provisions of section 16(b) of the Securities Exchange Act.<sup>3</sup> The district court held that the conversion of the

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<sup>34</sup> Cf. *Heli-Coil Corp. v. Webster*, 352 F.2d 156 (3d Cir. 1965).

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<sup>1</sup> 352 F.2d 156 (3d Cir. 1965).

<sup>2</sup> 48 Stat. 881 (1934), 15 U.S.C. § 78 (1964).

<sup>3</sup> (b) For the purpose of preventing the unfair use of information which may have been obtained by such beneficial owner, director, or

debentures into common stock was a "purchase" of the common and a "sale" of the debentures within the meaning of section 16(b)<sup>4</sup> and decided that Webster was therefore liable for profits derived from the "sale" of the bonds within six months of their "purchase," and for profits from the "sale" of the common within six months after it was "purchased" in the conversion transaction. An award of 116,544.36 dollars was rendered in favor of the corporation. The court of appeals affirmed the finding of the lower court, but decided that Webster had realized no "profit" within the meaning of section 16(b) from the "sale" of the debentures and reduced the judgment to 45,144.36 dollars, representing the profits from the "sale" of the common stock only.

Section 16(b) of the act provides for recovery by a corporation of any profits realized by an "insider" of the corporation if its securities are listed on a national exchange or traded over-the-counter and it has a total of 750 or 500 shareholders, depending upon the date, and assets of at least 1,000,000 dollars.<sup>5</sup> An "insider" is any officer, director, or ten per cent beneficial owner of any class of securities of the corporation.<sup>6</sup> Enforcement of this provision is aided by section 16(a), which requires that insiders of such corporations file reports as to their holdings and transactions in any of

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officer by reason of his relationship to the issuer, any profit realized by him from any purchase and sale, or any sale and purchase, of any equity security of such issuer (other than an exempted security) within any period of less than six months, unless such security was acquired in good faith in connection with a debt previously contracted, shall inure to and be recoverable by the issuer, irrespective of any intention on the part of such beneficial owner, director, or officer in intering into such transaction of holding the security purchased or of not repurchasing the security sold for a period exceeding six months. Suit to recover such profit may be instituted at law or in equity in any court of competent jurisdiction by the issuer, or by the owner of any security of the issuer in the name and in behalf of the issuer if the issuer shall fail or refuse to bring such suit within sixty days after request or shall fail diligently to prosecute the same thereafter; but no such suit shall be brought more than two years after the date such profit was realized. This subsection shall not be construed to cover any transaction where such beneficial owner was not such both at the time of the purchase and sale, or the sale and purchase, of the security involved, or any transaction or transactions which the Commission by rules and regulations may exempt as not comprehended within the purpose of this subsection.

48 Stat. 896 (1934), 15 U.S.C. § 78p(b) (1964).

<sup>4</sup> *Heli-Coil Corp. v. Webster*, 222 F. Supp. 831 (D.N.J. 1963).

<sup>5</sup> 78 Stat. 565, 15 U.S.C. § 78l (1964).

<sup>6</sup> See note 7 *infra*.

the corporation's equity securities.<sup>7</sup> The act was designed to insure to the public the maintenance of fair and honest markets in securities.<sup>8</sup> Section 16(b) itself was prompted by many abusive practices of corporate insiders in securities transactions prior to 1934.<sup>9</sup>

In its application, section 16(b) is meant to impose an objective, strict liability, requiring no proof of actual use of inside information.<sup>10</sup> The fact that the person comes under the definition of "insider" is sufficient.<sup>11</sup> This requirement is needed in order that the provision be effective, because of practical difficulties in proving use of such information. The strict wording of the statute notwithstanding, there is allowance for some administrative flexibility in that the Securities and Exchange Commission is given the power to make rules exempting from the section types of transactions that it believes were not comprehended to be within its purview.<sup>12</sup> The

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<sup>7</sup> (a) Every person who is directly or indirectly the beneficial owner of more than 10 per centum of any class of any equity security (other than an exempted security) which is registered pursuant to section 78l of this title, or who is a director or an officer of the issuer of such security, shall file, at the time of the registration of such security on a national securities exchange or by the effective date of a registration statement filed pursuant to section 78l(g) of this title, or within ten days after he becomes such beneficial owner, director, or officer, a statement with the Commission (and, if such security is registered on a national securities exchange, also with the exchange) of the amount of all equity securities of such issuer of which he is the beneficial owner, and within ten days after the close of each calendar month thereafter, if there has been a change in such ownership during such month, shall file with the Commission (and if such security is registered on a national securities exchange, shall also file with the exchange), a statement indicating his ownership at the close of the calendar month and such changes in his ownership as have occurred during such calendar month.

48 Stat. 896 (1934), 15 U.S.C. § 78p(a) (1964).

<sup>8</sup> Securities Exchange Act of 1934, 48 Stat. 881, 15 U.S.C. § 78b (1964).

<sup>9</sup> Among these were situations in which insiders with advance knowledge of facts that would depress the market price sold their stock at then current prices and repurchased when publication of the information had the anticipated effect, and situations in which insiders with advance knowledge would buy stock and sell after an anticipated subsequent rise in prices. See *Smolowe v. Delendo Corp.*, 136 F.2d 231, *cert. denied*, 320 U.S. 751 (1943); S. REP. NO. 792, 73d Cong., 2d Sess. 9 (1934).

<sup>10</sup> "[W]e are of the opinion . . . that it was the intention of Congress in enacting § 16(b) to obviate any necessity for a search of motives of the insider or require an investigation of whether or not his actions were animated by inside information to gain a speculative profit." *Heli-Coil Corp. v. Webster*, 352 F.2d 156, 165 (3d Cir. 1965).

<sup>11</sup> See *Blau v. Lehman*, 286 F.2d 786 (2d Cir. 1960), *aff'd*, 368 U.S. 403 (1962).

<sup>12</sup> See note 3 *supra*.

Commission has thus become the "watchdog" of section 16(b), by acting in this statutory capacity to prevent harsh liabilities.<sup>13</sup>

Under section 16(b), there must be a "purchase and sale," or "sale and purchase," and "profit realized" within the definition of the act.<sup>14</sup> The question whether conversion of a convertible security fits into these requirements is the problem in *Heli-Coil* and will be the concern of this note.

The act defines "purchase" as any "contract to buy, purchase, or otherwise acquire,"<sup>15</sup> and "sale" as "any contract to sell or otherwise dispose of."<sup>16</sup> Thus under section 16(b) the two terms are given broader definitions than those usually understood.<sup>17</sup> Some courts,<sup>18</sup> relying on *Park & Tilford, Inc. v. Schulte*,<sup>19</sup> one of the two leading decisions in the area, have decided that conversion of a convertible security into common stock is a "purchase" of that stock under section 16(b). In *Park & Tilford*, the defendants were beneficial owners of over ten per cent of the common stock of the corporation and of a large block of convertible preferred shares. The corporation gave notice of a redemption of the preferred, and the defendants then converted their preferred into common and sold at a profit within six months. The court found the conversion a "purchase" of the common and held the defendants liable for the profits of the subsequent "sale," reasoning that if conversion was not deemed a "purchase," it would put the defendant in a position to abuse any possession of inside information. The court had no difficulty with the fact that there was a call on the preferred shares, because the defendants had sufficient voting power to control the call.

The second of the leading decisions on this question is *Ferraiolo v. Newman*.<sup>20</sup> Here the defendant director owned convertible pre-

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<sup>13</sup> In the administration of § 16(b) the Securities and Exchange Commission has adopted twenty rules exempting various transactions in whole or in part from its provisions. Rules 16a-1 to -10, 17 C.F.R. § 240.16a-1 to -10 (1964); and rules 16b-1 to -10, 17 C.F.R. § 240.16b-1 to -10 (1964).

<sup>14</sup> See note 3 *supra*.

<sup>15</sup> Securities Exchange Act of 1934, 48 Stat. 882, 15 U.S.C. § 78c(a) (13) (1964).

<sup>16</sup> Securities Exchange Act of 1934, 48 Stat. 882, 15 U.S.C. § 78c(a) (14) (1964).

<sup>17</sup> See *Blau v. Lamb*, 163 F. Supp. 528 (S.D.N.Y. 1958).

<sup>18</sup> *E.g.*, *Heli-Coil Corp. v. Webster*, 352 F.2d 156 (3d Cir. 1965); *Blau v. Lamb*, *supra* note 17.

<sup>19</sup> 160 F.2d 984 (2d Cir.), *cert. denied*, 332 U.S. 761 (1947).

<sup>20</sup> 259 F.2d 342 (6th Cir. 1958), *cert. denied*, 359 U.S. 927 (1959).

ferred shares of the corporation, and a call was issued at a redemption price less than market price. To avoid loss, defendant converted the preferred to common and sold the common within six months. The court did not follow *Park & Tilford* but held instead that the preferred and common were substantial economic equivalents and that the conversion was in reality forced because defendant played no part in the call and had no power to control it. The transaction was found to be "not one that could have lent itself to the practices which section 16(b) was enacted to prevent."<sup>21</sup>

*Ferraiolo* has been criticized as advocating a *subjective* approach to liability under section 16(b) by requiring examination of the actual circumstances behind the conversion.<sup>22</sup> On the other hand, *Park & Tilford* has been favored as representing the *objective* approach to section 16(b)<sup>23</sup> by imposing liability as a rule of thumb if the transaction is of a type open to insider abuse by use of special information. As pointed out, the act itself requires an *objective* approach to liability. To take a *subjective* view would be to compromise the statute and hamper full realization of its purposes. Admittedly, there must be a policy determination made here, for an entirely objective approach will of necessity cause hardship when, as in *Ferraiolo*, there is a forced conversion. This hardship must, however, be weighed against the value of fully implementing the statute itself. When this consideration is viewed in conjunction with the power of the Commission to make exemptions from the section, the objective view seems to be correct.

The district court determined that *Heli-Coil* should be governed by *Park & Tilford*.<sup>24</sup> The defendant contended the case was analogous to *Ferraiolo*, arguing that there was no "purchase" of the common because the convertible and the common shares were substantial equivalents.<sup>25</sup> The court rejected this, seeing the distinction between *Park & Tilford* and *Ferraiolo* as the involuntary nature of the conversion in the latter case, and held the conversion a "purchase" of the common and, *in addition*, a "sale" of the con-

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<sup>21</sup> 259 F.2d at 346.

<sup>22</sup> *Heli-Coil Corp. v. Webster*, 352 F.2d 156, 164 (3d Cir. 1965); *Petteys v. Northwest Airlines, Inc.*, 246 F. Supp. 526, 529 (D. Minn. 1965). *But see* *Blau v. Max Factor & Co.*, 342 F.2d 304 (9th Cir. 1965).

<sup>23</sup> *Ibid.*

<sup>24</sup> *Heli-Coil Corp. v. Webster*, 222 F. Supp. 831 (D.N.J. 1963).

<sup>25</sup> 222 F. Supp. at 835.

vertible, purchased less than six months previously.<sup>26</sup> This was the first time a court had considered the conversion also to have been a "sale," and, though the idea was not mentioned in *Park & Tilford*, the *Heli-Coil* court had no trouble basing its decision on that case. It recognized that *Park & Tilford* had not actually dealt with this new question, but decided that its ratio decidendi would determine that issue.<sup>27</sup>

The ramifications of such a decision are apparent. By treating the paper profits on conversion as actual realized profits, the court subjects the insider to liability for two sets of "purchases" and "sales" rather than the customary one, thereby compelling the defendant to account for a far greater amount than he actually realized.<sup>28</sup> Thus, in *Heli-Coil* his liability was almost doubled—a harsh result adding an element of punishment to the usual liability under section 16(b). Sustaining this result would contravene the statute's remedial purpose<sup>29</sup> as much as adherence to the subjective standard suggested in *Ferraiolo*. This was the position of the Securities Exchange Commission when the lower court decision in *Heli-Coil* was rendered. In the court of appeals, the Commission, appearing as *amicus curiae*, asserted that section 16(b), literally construed, meant that conversion is both a "purchase" of the common shares and a "sale" of the convertible shares,<sup>30</sup> but introduced a "substantial and novel"<sup>31</sup> concept, arguing that defendant did not "realize" any profits in the "sale" at conversion.<sup>32</sup> It pointed out that the district court had not considered this issue and said that the words "profit realized" in the act mean a great deal more than mere paper profits, and

neither words used nor the statutory purpose calls for a finding that a profit was "realized" upon the conversion of the debentures under the circumstances of this case. When used with reference to investments, the term "realized" generally refers to the liquidation of an investment position and the collection of whatever profit has accrued. Although in some situations the statutory purpose may require a broader concept, this is not such a case.

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<sup>26</sup> *Ibid.*

<sup>27</sup> 222 F. Supp. at 834.

<sup>28</sup> For a discussion of the tremendous losses this can cause the defendant, see 19 RUTGERS L. REV. 151, 152 (1964).

<sup>29</sup> See *Ellerin v. Massachusetts Mut. Life Ins. Co.*, 270 F.2d 259 (2d Cir. 1959); *Adler v. Klawans*, 267 F.2d 840 (2d Cir. 1959).

<sup>30</sup> Brief for the SEC as *Amicus Curiae*, pp. 8-13, *Heli-Coil Corp. v. Webster*, 352 F.2d 156 (3d Cir. 1965).

<sup>31</sup> *Id.* at 13.

<sup>32</sup> *Ibid.*

In no real sense did Mr. Webster [the insider] liquidate his position or collect a profit when he converted. . . . After the conversion, as before . . . [he] retained his investment position in the securities of Heli-Coil and whatever profits had accrued continued to be at the risk of the market and could disappear without "realization" if the market price of the common were to decline substantially. In the parlance of investors, these profits continued to be "paper" profits both before and after the conversion.<sup>33</sup>

The court of appeals, adopting the Commission's position, said:

Measuring the terms "profit" and "realize" in conjunction, we think it is clear that Congress intended that ordinarily no gain in the value of securities should be deemed to be realized as a profit under the Act until there has been a definitive act by the owner of the securities whereby the paper value of the securities has become a real and an includible one—in the case at bar, by a sale of the common stock by Webster for cash.<sup>34</sup>

Accordingly, Webster's liability was reduced to the actual profit "realized," this being the difference between the value of the common at conversion, and its subsequent sales price.

Practically the same issue as that presented in *Heli-Coil* has arisen in *Blau v. Lamb*,<sup>35</sup> a case now on appeal to the Second Circuit. There the defendants acquired convertible preferred shares, within six months converted into common, and then sold the common within six months. The court below held that the transaction constituted a "purchase" of the common, and a "sale" of the convertible preferred.<sup>36</sup> The Securities and Exchange Commission, as *amicus curiae*, cited *Heli-Coil* and took the same position it had taken there, saying that

the court below correctly held that the voluntary conversion of preferred stock into common stock constituted a "sale" of the preferred and a "purchase" of the common. . . . However, that . . . under the circumstances of this case, no profit was realized by Appellants from the disposition of the preferred stock upon conversion.<sup>37</sup>

It will not be surprising if the Second Circuit in *Blau v. Lamb* follows the "no profit realized" position of the Commission as did

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<sup>33</sup> *Id.* at 14, 15.

<sup>34</sup> *Heli-Coil Corp. v. Webster*, 352 F.2d 156, 167-68 (3d Cir. 1965).

<sup>35</sup> 242 F. Supp. 151 (S.D.N.Y. 1965).

<sup>36</sup> *Ibid.*

<sup>37</sup> Brief for the SEC as Amicus Curiae, p. 5, *Blau v. Lamb*, 242 F. Supp. 151 (S.D.N.Y. 1965).

the Third Circuit in *Heli-Coil*. This would be only proper in view of the closeness of the Commission to such transactions and its statutory power as "watchdog" over section 16(b).<sup>38</sup> The approach in *Heli-Coil* is a novel one; however, convincing as it may be, it is difficult to avoid the impression that it is actually no more than a stopgap—giving the courts an opportunity to impose a reasonable liability in accordance with the purpose of section 16(b) while allowing the Commission a chance to formulate and express its own policy by adopting rules of exemption. This impression is strengthened by the fact that the Commission recently has passed an amendment to its rule 16b-9<sup>39</sup> that will apparently remedy the problems discussed here. Previously, rule 16b-9 allowed an exemption from 16(b), under certain circumstances, for acquisitions and dispositions of securities in the conversion of one class of security into another class that has *similar characteristics*.<sup>40</sup> The amendment *extends* the exemption to

conversion of an equity security convertible into any class of equity security of the same issuer; provided that, no more than 15 per cent of the value of the security received at the time of conversion is received or paid, in cash or other property (other than the convertible security given in exchange), in connection with the conversion.<sup>41</sup>

This rule will apparently cause the six month short-swing period to be measured from the time of "purchase" of the convertible security, to the time of the "sale" of the "security as to which the conversion privilege relates,"<sup>42</sup> and *will* allow profits realized

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<sup>38</sup> See notes 3 and 13 *supra*.

<sup>39</sup> See note 42 *infra*.

<sup>40</sup> Rule 16b-9, 17 C.F.R. 240.16b-9 (1964).

<sup>41</sup> Notice of Proposal to Amend Rule 16b-8 and Rule 16b-9 Under the Securities Exchange Act of 1934, SEC Release, No. 7750, Nov. 27, 30 Fed. Reg. 14742 (1965).

<sup>42</sup> The full text of the rule as amended by SEC Release, No. 7826, Feb. 17, 31 Fed. Reg. — (1966): § 240.16b-9 Exemption from section 16(b) of transactions involving the conversion of equity securities.

(a) Any acquisition or disposition of an equity security involved in the conversion of an equity security, which, by its terms or pursuant to the terms of the corporate charter or other governing instruments, is convertible immediately or after a stated period of time into another equity security of the same issuer, shall be exempt from the operation of Section 16(b) of the Act; *Provided, however*, That this rule shall not apply to the extent that there shall have been either (i) a purchase of any equity security of the class convertible (including any equity security of the class issuable upon conversion, or (ii) a sale

from any such sale or purchase transactions to be recovered by the corporation. Its impact in cases such as *Heli-Coil* or *Blau v. Lamb* is obvious, for in either situation it possibly would have relieved the defendant of all liability under section 16(b).<sup>43</sup>

Thus, by the amendment, the Securities and Exchange Commission has acted as quickly as could be expected to remedy an unfortunate development under section 16(b) of the Securities Exchange Act of 1934. The new rule will terminate any questions on the propriety of the *Heli-Coil* decision.<sup>44</sup>

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of any equity security of the class convertible and any purchase of any equity security issuable upon conversion, (otherwise than in a transaction involved in such conversion or in a transaction exempted by any other rule under Section 16(b) within a period of less than six months which includes the date of conversion.

(b) For the purpose of this rule, an equity security shall not be deemed to be acquired or disposed of upon conversion of an equity security if the terms of the equity security converted require the payment or entail the receipt, in connection with such conversion, of cash or other property (other than equity securities involved in the conversion) equal in value at the time of conversion to more than 15% of the value of the equity security issued upon conversion.

(c) For the purpose of this rule, an equity security shall be deemed convertible if it is convertible at the option of the holder or of some other person or by operation of the terms of the security or the governing instruments.

<sup>43</sup> *Ibid.*

<sup>44</sup> In relation to the amendment, the Commission has moved for leave to file as amicus curiae in the case of *Petteys v. Northwest Airlines, Inc.*, 246 F. Supp. 526 (D. Minn. 1965), now on appeal to the Eighth Circuit. This case presents a situation different from—but closely related to—that in *Heli-Coil* and *Blau v. Lamb*. In *Petteys* the defendants held convertible securities more than six months and then converted to common when a call on the shares was issued, selling the common shares within six months of the conversion. The district court, applying very strictly the objective standard established by *Park & Tilford*, held that the conversion, though involuntary (defendants were directors, but had no control over the call), and the subsequent "sale" of the common constituted a "purchase" and "sale" under section 16(b). The case is thus diametrically opposed to the position taken in *Ferraiolo* by the Sixth Circuit. The Commission has directed the court's attention to the amendment to rule 16b-9, which "would have an impact on the factual situations such as those in this case." See Motion Re Amicus Curiae Participation by SEC, p. 2, *Petteys v. Northwest Airlines, Inc.*, *supra*. The Commission does point out, however, that the new rule would not apply to cases such as *Petteys*, where judgment has already been rendered, but it apparently feels that the Eighth Circuit will give weight to the new rule in its determination of the case. It seems that the court of appeals should do this, because of the Commission's statutory position under section 16(b), and its obvious feeling that section 16(b) was not intended to produce liability in the ordinary security conversion transaction.