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tion. Instead it reapplied the rule of thirty years ago, that airports are not one of those purposes which may be considered "necessary" within the meaning of article VII, section 6.

In Goswick v. Durham, the first of the "airport cases," the opinion noted that "The law is an expanding science, designed to march with the advancing battalions of life and progress and to safeguard and interpret the changing needs of a commonwealth or community." It is questionable whether the court in Royster has stayed in step with those battalions.

WILLIAM VANN MCPHERSON, JR.

Securities Regulations—Convertible Debentures Not A Class of Equity Security

In Chemical Fund, Inc. v. Xerox Corp., the Second Circuit Court of Appeals was for the second time faced with construing the meaning of "any class of any equity security" in section 16 of the Securities Exchange Act of 1934. Chemical Fund is an open end diversified investment company. Early in December 1962, the Fund owned 91,000 shares which represented 2.36 percent of the Xerox common stock. In 1961 the Fund acquired four and one

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211 N.C. at 690, 191 S.E. at 730.

1 377 F.2d 107 (2d Cir. 1967).

2 In Ellerin v. Massachusetts Mut. Life Ins. Co., 270 F.2d 259 (2d Cir. 1959), the court held that the ten percent holder of a series of stock was not the ten percent holder of a class of equity security for the purposes of section 16(b).

3 Section 16(a) of the statute defines insider for the purposes of the statute as "Every person who is directly or indirectly the beneficial owner of more than ten percentum of any class of any equity security ... or who is a director or an officer of the issuer of such security ... ." Securities Exchange Act of 1934, 15 U.S.C. § 78p(a) (1964). The section under consideration in the principal case reads:

For the purpose of preventing the unfair use of information which may have been obtained by such beneficial owner, director, or 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 entering into such transaction of holding the security purchased or of not repurchasing the security sold for a period exceeding six months. . . .


4 At that time Xerox had 3,851,844 shares of common stock outstanding. Chemical Fund, Inc. v. Xerox Corp., 377 F.2d 107, 110 (2d Cir. 1967).
half percent convertible subordinate debentures due May 1, 1981. Each 1,000 dollar debenture was convertible into approximately nine and one half shares of common stock and was protected against dilution of the conversion right, but carried no immediate participation in the equity of Xerox. From December 4 through 20, 1962 and again from April 24 through August 2, 1963, the Fund purchased debentures convertible into 3,029 shares of common and sold 3,000 shares of common stock. Besides this sale of 3,000 shares offset by the purchase of debentures, the Fund sold an additional 13,500 shares of common. These purchases and sales were part of a program designed to increase Chemical Fund's secured position and improve its yield from its Xerox investment without sacrificing its ability to take advantage of the continuing appreciation of Xerox common stock. With the purchase of 11,000 dollars principal amount of debentures on December 4 and again on December 12, 1962, however, Chemical Fund became the holder of more than ten percent of the outstanding convertible debentures, a position it held until November, 1963. As a result, Chemical Fund sought declaratory judgment in the district court as to whether the profits made from the sales of common stock and purchases of debentures between December 1962 and November 1963 would inure to Xerox as a violation of section 16(b). The district court granted summary judgment to Xerox for 153,922.43 dollars without interest.

On appeal the court of appeals reversed, holding that Chemical Fund was not liable under section 16(b) for short swing profits as a beneficial owner of ten percent of "any class of any equity security," for had Chemical Fund converted its debentures, it would have commanded only 2.72 percent of the Xerox common stock. Reasoning that a convertible debenture is an "equity security" only because of its convertible nature, the court held that the debentures alone would not be a "class of equity security." According to the court, the holder of convertible debentures would not normally have standing with officers, directors or large stockholders to be the recipient of inside information. Consequently, Chemical Fund would be outside the purview of the statute, for, as the court states, "the

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6 The Fund continued to hold more than ten percent of the convertible debentures until November 22, 1963, when pursuant to a call for redemption it converted the debentures into 17,180.95 shares of common stock. Id.

6 377 F.2d at 111.

7 Id.
purpose of section 16 to impose liability on the basis of actual or potential control is clear, and we should give it effect."

By exempting the holder of ten percent of the convertible debentures, it is questionable whether the court gave effect to the stated purpose of the statute—to prevent the unfair use of inside information.9 The court based its decision on control and seemed to equate "control" for the purposes of section 16(b) with ownership of ten percent of the common stock. This note is thus directed to the question of whether ownership of ten percent of the underlying common stock is necessary for the convertible debenture holder to be party to the abuses which 16(b) was designed to prevent.

At the time the Securities Exchange Act of 1934 was passed, "profits from 'sure thing' speculation were regarded by members of the financial community as one of the usual emoluments of office."10 As cases indicate, the entire purpose of section 16(b) is "to discourage corporate insiders from trading for short swing profits on the basis of information about corporate circumstances, plans and prospects not available to the public,"11 and "to establish a standard so high as to prevent any conflict between the selfish interest of a fiduciary officer, director, or stockholder and the faithful performance of his duty."12 To put teeth into the statute Congress required that profits made on short swing—six months—transactions be forfeited to the corporation. Congress indicated its desire to minimize misuse of confidential information, without unduly discouraging bona fide long term investment, by basing forfeiture of profits on the length of the insider's investment commitment.13 The statute is remedial in operation, and regardless of whether the in-

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8 Id.
11 Heli-Coil Corp. v. Webster, 352 F.2d 156, 172 (3d Cir. 1965).
12 Smolowe v. Delendo Corp., 136 F.2d 231, 239 (2d Cir. 1943); see Petteys v. Butler, 367 F.2d 528 (8th Cir. 1966), cert. denied, 385 U.S. 1006 (1966) (In this case the court commented that "[a]rmed with information not available to ordinary stockholders, these 'insiders' brought about artificial, but predictable, fluctuations in the market and, in so doing, were able to reap substantial profit with little or no investment risks to themselves—all at the expense of outside stockholders. . .IRO. 367 F.2d at 352); Perfect Photo, Inc. v. Grable, 205 F. Supp. 569, 571 (1962).
13 Blau v. Max Factor & Co., 342 F.2d 304 (9th Cir. 1965), cert. denied, 382 U.S. 892 (1965). In this decision the court pointed out that confidential information is valuable for just a short period and that the attractiveness of trading is enhanced if the capital is invested for only a short time. 342 F.2d at 308.
sider actually uses information, he must forfeit profits from short term speculation.  

On the issue of whether convertible debentures are a "class of equity security" Chemical Fund was a case of first impression. However, an examination of the Second Circuit's interpretation of 16(b) in relation to other issues such as conversion as a purchase and sale, recapitalization, and stock options reveals an interesting trend in the court's attitude toward and application of this seemingly absolute, arbitrary statute. When the court first interpreted the rule in Smolowe v. Delendo Corp. and later in Park & Tilford v. Shulte, Inc., it adhered to the idea that the statute was an absolute "crude rule of thumb." There was little consideration of surrounding factors which might justify or delimit the application of this somewhat harsh rule. The fact that the Shulte brothers in Park & Tilford could have prevented the dividend declaration because of the control which they exerted over the corporation was mentioned as a collateral point; nevertheless, the court based its decision on the broad language of the statute designed to deprive the violator of all possible profit. In its later decisions the Second Circuit moved away from this automatic application of 16(b) and began to inquire into the possibility for speculation in a given situation. Blau v. Lamb, a 1966 case, involved controlling insiders

14 According to Rheem Mfg. Co. v. Rheem, 295 F.2d 473, 475 (9th Cir. 1961), "[t]he excuses of various insider transactions which were presented to Congressional Committees convinced the authors of the legislation that civil liability and an objective measure of proof were indispensable ingredients of an effective remedy for the proven vice." See Western Auto Supply Co. v. Gamble-Skogmo, Inc. 348 F.2d 736 (8th Cir. 1965); B.T. Babbit, Inc. v. Lachner, 332 F.2d 255 (2d Cir. 1964).  


16 Thomas G. Corcoran, the draftsman of the Securities Exchange Act of 1934 used the term "crude rule of thumb" to describe 16(b). Hamilton, Convertible Securities and Section 16(b): The End of an Era, 44 Tex. Rev. L. 1447, 1448 n.6 (1966) [Hereinafter cited as Hamilton].  

17 In this opinion the court declared, "There is no rule of thumb, nor would it be wise to attempt to formulate such a rule." 286 F.2d at 792. Where the defendant became a director after his initial purchase and then sold stock, the court applied its original test, stating: "it [the statute] must be strictly construed in favor of the corporation and against any person who makes profit dealing in the corporation stock." Adler v. Klawans, 267 F.2d 840, 846 (2d Cir. 1959). In Roberts v. Eaton, 212 F.2d 82 (2d Cir. 1954), cert. denied, 348 U.S. 827 (1954), involving a reclassification in which full
who clearly had the power to misuse inside information. The court asked whether there was the slightest opportunity to exercise that power and stated:

[W]e reject the possible suggestion in the lower court’s opinion that the existence of an opportunity for speculative profits can be inferred from the fact of control alone, because such a suggestion is inconsistent with our responsibility to analyze the conversion in order to determine whether the possibility of unfair speculative profits might have existed at all even with full corporate control.22

Other circuits interpreting the statute have followed the pattern of the Second Circuit with one notable exception.23 In spite of the Second Circuit’s bold declaration in Blau v. Lamb, the court in Chemical Fund seems to have expanded the test requiring “opportunity for speculation” by the requirement that in order for there to be inside information for “speculation” there must be control over the common stock, thus moving completely away from the broad remedial application of the rule in Park & Tilford which would make the officer, director, or ten percent beneficial holder liable irrespective of actual knowledge, speculation or control.

As a practical matter, it is possible for the ten percent convertible debenture holder to have inside information and to engage in the abuses that rule 16(b) was intended to halt. An examination of three factors may aid in understanding this problem. In the first place, the convertible debenture holder by the very nature of the security has the opportunity for speculation and quick profit—the evils prohibited by the statute. Many investors view convertible issues as an opportunity for profit with small risk.24 In a sense


disclosure had been made, the court said that “[t]he reclassification at bar could not possibly lend itself to the speculation encompassed by § 16(b).” 212 F.2d at 86. One opinion states, “And speculation, actual or potential, is the only vice within the purview of § 16(b).” Blau v. Ogsbury, 210 F.2d 426, 427 (2d Cir. 1954); see also Shaw v. Dreyfus, 172 F.2d 140, 142 (2d Cir. 1949).

22 363 F.2d 507 (2d Cir. 1966), cert. denied, 385 U.S. 1002 (1967).

23 Id. at 521.

24 In Heli-Coil Corp. v. Webster, 352 F. 2d 156, 166 (3d Cir. 1965), the court applied the crude rule of thumb. For cases in which courts looked for the speculative aspect, see Petteys v. Butler, 367 F.2d 528 (8th Cir. 1966), cert. denied, 385 U.S. 1006 (1966); Blau v. Max Factor & Co., 342 F.2d 304 (9th Cir. 1965), cert. denied, 382 U.S. 892 (1965); Ferraiolo v. Newman, 259 F.2d 342 (6th Cir. 1958).

these securities are favorable to both the investor and the corporation since the investor has the protection of a bond or preferred stock plus the possibility of participation in any substantial rise in the value of the common.25 Using the six months limitation, Congress drew a practical line prohibiting profit made with the aid of inside information while simultaneously permitting bona fide investment by the insider.26 The person holding convertible debentures is in a position analogous to the holder of preferred stock with warrants or option privileges. Until the option is exercised, the holder does not bear the same risk as the owner of the junior security even though the market price of the security may at times be based upon the value of the junior security.27 Similarly, until the convertible debenture holder converts, he does not have the same risk as the owner of the underlying security. Although the court in Chemical Fund treated the purchase of the convertible debentures as the purchase of the underlying securities,28 a purchase of convertible securities is not considered such for all purposes.29 As some authorities indicate, the fungible nature of convertible securities makes them attractive for insider speculation in situations such as Chemical Fund where the owner purchases the convertible security and offsets the purchase with a transaction in the conversion security.30 Thus with limited risk the convertible debenture holder can make considerable profit through speculation. Therefore, the holder of ten percent of the convertible debentures of a corporation should not be allowed to escape the burden of section 16(b) unless he holds for the required six months necessary to make his purchase a bona fide investment.

In the second place, when compared with preferred stock, which would certainly be a "class of equity security" within the scope of 16(b), there is little reason not to label convertible debentures as a class of equity security. From the standpoint of control, the rights

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25 Id. at 601.
26 Meeker and Cooney, The Problem of Definition in Determining Insider Liabilities Under Section 16(b), 45 VA. L. REV. 949, 963 (1959) [Hereinafter cited as Meeker].
27 Id. at 964.
28 377 F.2d at 110. The court said that a convertible debenture was "an equity security only because it can be converted," and that to determine if ten percent of the convertible debentures would be ten percent of a class of equity security, there must be a hypothetical conversion.
29 Hamilton 1491.
30 Id. at 1488; Meeker 960-61.
held by each are relatively equal. Although neither usually has voting rights, some states permit the corporation to give the debenture holder voting and inspection rights.\textsuperscript{31} While the preferred stockholder can bring a derivative suit, the debenture holder can sue in case of default in payment.\textsuperscript{32} Also the debenture holder has a degree of control over the corporation through the restrictions on corporate activities set forth in the indenture.\textsuperscript{33} Given these circumstances, to include preferred stock under 16(b) and exclude convertible debentures seems slightly inconsistent.

Finally, the holder of ten percent, and for that matter lesser amounts, of the convertible debentures in a corporation will probably have access to inside information, especially if the debenture holder is a large institutional investment company such as Chemical Fund. Institutional investment companies are powerful, holding in the aggregate approximately thirty to forty percent of the aggregate value of all common stocks listed on the New York Stock Exchange.\textsuperscript{34} These companies can be quite helpful to portfolio companies in locating needed capital and furnishing expert advice on financing and management. As one authority points out, investment company officers and analysts are often in contact with the officers and directors of the companies in which the investment company has holdings.\textsuperscript{35} Such contact creates relationships of confidence which permit the art of gentle persuasion and result in the institutional investor being sought for advice.\textsuperscript{36} Thus, although this authority contends that the investment company shuns favoritism and direct involvement in the control of the portfolio companies,\textsuperscript{37}

\textsuperscript{31} E.g., Del. Code Ann. Title 8, § 221 (1953); N.Y. Bus. Corp. Law § 518c (McKinney 1963).
\textsuperscript{32} As a practical matter instead of suing, the debenture holder usually reaches a compromise with the corporation, a point which illustrates the give and take between the corporation and the debenture holders.
\textsuperscript{33} As stated in the XEROX ANNUAL REPORT at 40 (1962), “Under the terms of the several loan agreements and the indenture, varying restrictions exist. At Dec. 31, 1962 among other conditions, the company was required to limit investments in other subsidiaries and additional indebtedness and to maintain consolidated working capital (as defined) equal to consolidated aggregate indebtedness (as defined). In addition, restrictions exist on the payment of cash dividends on common stock.”
\textsuperscript{34} See generally, Brown, The Institutional Investor As a Shareholder, in CONFERENCE ON SECURITIES REGULATIONS 209 (R. Mundheim ed. 1964).
\textsuperscript{35} Id. at 215-16.
\textsuperscript{36} Id.
\textsuperscript{37} Id. at 213.
they are in a strategic position for access to inside information which may be valuable in speculation.

The use of ten percent in the statute is an arbitrary figure. From the legislative history it is evident that Congress recognized the possibility that the holder of less than ten percent of an equity security might be in control of the corporation.\(^3\) It should be noted, however, that in the statute Congress did not mention "control." Instead it chose the arbitrary ten percent beneficial owner of any class of any equity security, thereby making a distinction between control and the use of inside information. In *Gratz v. Claughton*,\(^3\) Judge Hand emphasized the idea that the legislature may adopt whatever measure is necessary to deal with the harm although sometimes it applies to situations where the evil is not present.\(^4\)

For authority that the legislature's intent in passing the Act was for the convertible debentures to be an equity security only in relation to the conversion security, the court in *Chemical Fund* cited the legislative hearings pointing out that in the original draft bondholders were mentioned specifically, but were omitted in the final bill.\(^4\)

As one writer has stated:

What constitutes an equity security has been the subject of considerable difference of opinion. Any definition must be couched in broad language if it is to be applicable to the infinite variety of security issues and is to thwart ingenious attempts to escape its terms.\(^2\)

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\(^3\) 78 CONGRESSIONAL RECORD 8037 (1934) (Mr. Lea answering Mr. Pettingill's motion to strike out "beneficial owner" in the bill): I recognize the fact that the five percent [later changed to ten percent] line is an arbitrary one. It is variable in its effects in reference to different corporations. As to all corporations listed on the great exchanges of the country, five percent represents an important part of the stock of such corporations. It is so commonly the case that a man who owns a large amount of stock, but nothing like a majority, controls the directors of the corporation that the committee thought it was advisable to require these large stockholders who may be trafficking in the stock of the corporation to reveal the facts. Mr. Rayburn, speaking before the House, said: "We know, however, that in the case of any corporation having widely scattered stockholders the concentration of five or ten or twenty or thirty percent of stock ownership is control; they can always get the proxies." *Id.* at 8038.

\(^4\) 187 F.2d 46 (2d Cir. 1951).

\(^5\) If the plaintiff had the burden of proving that the defendant had a bargaining advantage, the purpose of the statute would be defeated. *Id.* at 49.

\(^6\) 377 F.2d 107, 111 n. 6 (2d Cir. 1967).

\(^7\) Cook 393.
The definition of an equitable security as "any stock or similar security; or any security convertible. . . into such a security . . ." could represent a compromise position in which Congress recognized the possibility that holders of convertible debentures might engage in speculation and thus fall within the policy of the statute.

Interpreting section 16(b) in cases from Smolowe through Chemical Fund, the court used three basic tests—the automatic "crude rule of thumb," the opportunity for speculation, and finally control. The validity of these tests must be governed by the policy and purpose of the statute—to prevent the unfair use of inside information. The court in Chemical Fund held that ten percent of the convertible debentures alone would not constitute a class of equity security. In light of the purpose of the statute, did the court reach a result in harmony with the statutory objectives by basing liability on control—actual or potential? An affirmative answer to this question is doubtful. The facts disclose that an institutional investment company holding convertible debentures could have access to inside information and could use this information for speculation to the detriment of outside shareholders. Furthermore, the legislative history reveals that Congress drew an arbitrary line of ten percent and did not intend control as the criterion. Thus had the Second Circuit used the Blau test—opportunity for speculation—the decision would probably have been more in keeping with the legislative purpose and policy of the statute. Section 16(b) is remedial, not penal, and the interpretation must be given which is most consistent with the legislative intent. As one writer has commented: "[I]n view of the history and apparent purpose of this legislation, the fundamental consideration in all doubtful cases should be 'not whether the defendant actually used inside knowledge to profit, but rather whether the situation was one in which such in-

44 For commentary on the various tests applied by the courts see Hamilton 1454-58.
46 Adler v. Klawans, 267 F.2d 840, 844 (2d Cir. 1959).
side knowledge could have been advantageously used.' To require control in terms of ten percent of the common stock diminishes the effectiveness of the statute. The statute itself vests the power in the Securities Exchange Commission to exempt certain securities and transactions, and exceptions to the statute should not be created by narrow judicial interpretation. One authority is of the opinion that "the express purpose of preventing the unfair use of inside information might suggest an application of the statute to all cases which may come literally within its scope." By virtue of the ten percent and six months arbitrary cut off points, the statute is already limited, and the court should not limit further what is remedial legislation when, as in Chemical Fund, there is the slightest possibility for unfair use of inside information.

Sarah E. Parker

Torts—Dignity As a Legally Protectable Interest

A recent New Jersey decision presents the question of what injury, if any, has been suffered by a mother who has been denied the opportunity to obtain an abortion. Plaintiffs, a defective infant and his parents, brought a malpractice action against the mother's obstetricians alleging that they negligently assured Mrs. Glietman that her recent illness of German measles would not affect the infant then in gestation. The basis of plaintiffs' claim was that defendants' repeated assurances induced Mrs. Glietman

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48 Cook 387.
49 Hamilton 1455.
50 Meeker 958.
51 Adler v. Klawans, 267 F.2d 840 (2d Cir. 1959). As the opinion states, "One can speculate on whether the moral or ethical values are altered by the passage of 24 hours, but the statute makes an honest if not an honorable man out of the insider in that period." Id. at 845. A line had to be drawn somewhere by the lawmakers as in any other area governed by statute.
53 At present it is well established that rubella virus can cause malformations of the eye (cataract and microphthalmia); internal ear (congenital deafness due to destruction of the Organ of Corti); heart (persistence of the ductus arteriosus as well as atrial and ventricular septal defects); and occasionally of the teeth (enamel layer). The virus may also be responsible for some cases of brain abnormalities and mental retardation.
J. Langman, Medical Embryology 73 (1963). In the principle case the infant had substantial defects in sight, hearing, and speech.