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INSIDER LIABILITY UNDER SECTION 16(b) REQUIRES A FINDING OF
DIRECT PECUNIARY BENEFIT

CBI Industries, Inc. v. Horton, 682 F.2d 643 (7th Cir. 1982)

In *CBI Industries, Inc. v. Horton*¹ the Seventh Circuit Court of Appeals held that a corporate director who purchased stock of the corporation within six months of selling some of his own shares was not liable to the corporation for his profits under section 16(b)² of the Securities Exchange Act of 1934,³ when he purchased the stock in his capacity as co-trustee of two irrevocable trusts created for the benefit of his two adult sons.

The defendant Horton, a director of plaintiff CBI Industries ("CBI"), sold 3000 of his shares of CBI common stock on the open market in October of 1980 for \$61.50 per share.⁴ In March of 1981 Horton made an open market purchase of 2000 shares of the stock, at \$48.875 per share,⁵ for two trusts of which he was co-trustee and his two adult sons

1. 682 F.2d 643 (7th Cir. 1982).

2. This section, codified at 15 U.S.C. § 78p(b) (1976), provides as follows:

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. 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.

Application of this provision extends to "[e]very 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) . . . or who is a director or an officer of the issuer of such security . . ." *Id.* at § 78p(a).

3. Securities Exchange Act, ch. 404, 48 Stat. 881 (1934) (codified as amended at 15 U.S.C. §§ 78a-78kk (1976)).

4. *CBI Industries, Inc. v. Horton*, 530 F. Supp. 784, 785 (N.D. Ill.), *rev'd*, 682 F.2d 643, 644 (7th Cir. 1982).

5. 682 F.2d at 644. Although the Seventh Circuit assumed that Horton bought the shares

were beneficiaries.⁶ CBI subsequently brought suit⁷ to recover Horton's short-swing profits.⁸ The District Court for the Northern District of Illinois granted CBI's motion for summary judgment, ruling that Horton was the beneficial owner,⁹ as a matter of law, of the stock that he purchased for the trusts.¹⁰ The Seventh Circuit, in a two to one decision,¹¹ reversed and *held*: A corporate insider is not liable to the corporation for his profits from a short-swing transaction except to the extent that he realizes a direct pecuniary benefit.¹²

Prior to the enactment of the Securities Exchange Act of 1934, investors considered the use of confidential information by corporate insiders for personal financial gain a normal incident of high corporate

for the trusts, the district court implied that the co-trustee had actually made the purchase. 530 F. Supp. at 785.

6. 682 F.2d at 644. At the time of the contested transactions, Horton's sons were nineteen and twenty-two years old, attended school full-time, and lived apart from their father most of the year. *Id.* Only the younger son received full financial support from Horton. 530 F. Supp. at 786.

7. Federal jurisdiction was founded on the Securities Exchange Act of 1934 § 27, 15 U.S.C. § 78aa (1976), which gives federal courts exclusive jurisdiction over actions involving violations of the Securities Exchange Act.

8. A short-swing transaction occurs when a corporate insider effects a purchase and sale, or sale and purchase, of the corporation's stock within the statutory six month period. *See, e.g.,* Great W. United Corp. v. Kidwell, 577 F.2d 1256, 1272 n.32 (5th Cir. 1978), *rev'd on other grounds sub nom.* Leroy v. Great W. United Corp., 443 U.S. 173 (1979). Short-swing profits under section 16(b) arise when the insider purchases stock in the corporation and within six months sells it at a higher price, or when he sells the stock and within six months repurchases it at a lower price. *See* W. PAINTER, FEDERAL REGULATION OF INSIDER TRADING 25 (1968). As the court in *Horton* observed, "profit" in the latter instance is an avoided loss. 682 F.2d at 644. *But cf.* S. & S. Realty Corp. v. Kleer-Vu Indus., Inc., 575 F.2d 1040, 1044 (2d Cir. 1978) ("The word 'recoverable' implies the existence of a tangible asset or a fund. One would be hard put to recover the avoidance of a loss.").

9. It is important to bear in mind the two distinct senses in which "beneficial owner" is used in section 16(b) litigation. The term's first use is to identify a class of individuals (insiders) who are subject to the provisions of section 16. Specifically, the section applies to directors, officers, and *beneficial owners* of more than ten percent of a class of equity securities. *See supra* note 2. Courts have also used the term to determine whether an insider is liable under section 16(b). The corporation may recover from the insider the short-swing "profit realized by him" where he beneficially owns the shares (or their proceeds) used in the allegedly improper transaction. *See infra* notes 32-61 and accompanying text. The cases discussed herein involve beneficial ownership in the latter sense. That is, the person defending himself against the corporate claim is admittedly an insider subject to section 16, and the court must determine whether he is liable under section 16(b). *See* Whiting v. Dow Chem. Co., 386 F. Supp. 1130, 1131-32 (S.D.N.Y. 1974), *aff'd*, 523 F.2d 680 (2d Cir. 1975).

10. 530 F. Supp. at 786.

11. Circuit Judge Wood dissented in part. 682 F.2d at 647.

12. *Id.* at 646.

office.¹³ Section 16 of the Act¹⁴ sought to prevent what Congress perceived as unfair stock price manipulation by corporate officials dealing in their company's securities,¹⁵ and to renew investor confidence in the exchange markets.¹⁶ Accordingly, courts have generally interpreted the section as protecting outsider shareholders—those without access to confidential information.¹⁷

The remedy chosen by Congress to prevent the unfair use of inside information¹⁸ requires that a corporate insider surrender to the corporation¹⁹ his short-swing profits, regardless of whether he actually used

13. 10 SEC ANN. REP. 50 (1944); 2 L. LOSS, *SECURITIES REGULATION* 1037 (2d ed. 1961). Cf. S. THOMPSON, *LIABILITY OF DIRECTORS AND OTHER OFFICERS AND AGENTS OF CORPORATIONS* 360-61 (1880) (director need only disclose transactions "which will benefit [him] in any manner different from the manner in which all the shareholders will be benefitted").

14. For more information on section 16(b), see generally Cook & Feldman, *Insider Trading Under the Securities Exchange Act*, 66 HARV. L. REV. 385 (1953); Rubin & Feldman, *Statutory Inhibitions Upon Unfair Use of Corporate Information by Insiders*, 95 U. PA. L. REV. 468 (1947); 2 J. CORP. L. 188 (1976); Annot., 40 A.L.R.2d 1346 (1955 & Supp. 1982).

15. A list of these manipulative practices is set out in Letter from the Counsel for the Senate Committee on Banking and Currency to the Senate Banking and Currency Committee (Feb. 18, 1933), reprinted in 5 J. ELLENBERGER & E. MAHAR, *LEGISLATIVE HISTORY OF THE SECURITIES ACT OF 1933 AND SECURITIES EXCHANGE ACT OF 1934*, Item 15 at 32 (1973). For some specific examples of insider abuse, see S. REP. NO. 792, 73d Cong., 2d Sess. 7-9, reprinted in 5 J. ELLENBERGER & E. MAHAR, *supra*, at Item 17; S. REP. NO. 1455, 73d Cong., 2d Sess. 55-68, reprinted in 5 J. ELLENBERGER & E. MAHAR, *supra*, at Item 21.

16. H.R. REP. NO. 1383, 73d Cong., 2d Sess. 13, reprinted in 5 J. ELLENBERGER & E. MAHAR, *supra* note 15, at Item 18. See also *Wagman v. Astle*, 380 F. Supp. 497, 501 (S.D.N.Y. 1974).

17. E.g., *Smolowe v. Delendo Corp.*, 136 F.2d 231, 239 (2d Cir.), cert. denied, 320 U.S. 751 (1943); *Epstein v. Shindler*, 200 F. Supp. 836, 837 (S.D.N.Y. 1961); *Fistel v. Christman*, 133 F. Supp. 300, 303 (S.D.N.Y. 1955); *Roberts v. Eaton*, 119 F. Supp. 362, 365 (S.D.N.Y. 1953), *aff'd*, 212 F.2d 82 (2d Cir.), cert. denied, 348 U.S. 827 (1954); 2 L. LOSS, *supra* note 13, at 1041. Cf. *Champion Home Builders Co. v. Jeffress*, 490 F.2d 611, 619 (6th Cir.), cert. denied, 416 U.S. 986 (1974) (statute protects both minority shareholders and the general public); *Magida v. Continental Can Co.*, 231 F.2d 843, 846 (2d Cir.), cert. denied, 351 U.S. 972 (1956) (same).

18. Several commentators have suggested that insider trading can produce an economic benefit by providing outsider shareholders with accurate information concerning the worth of their securities. See, e.g., H. MANNE, *INSIDER TRADING AND THE STOCK MARKET* (1966); H. MANNE & E. SOLOMON, *WALL STREET IN TRANSITION* (1974); Wu, *An Economist Looks at Section 16 of the Securities Exchange Act of 1934*, 68 COLUM. L. REV. 260 (1968). For responses to Professor Manne's criticisms of the insider trading rules, see Schotland, *Unsafe at Any Price: A Reply to Manne*, *Insider Trading and the Stock Market*, 53 VA. L. REV. 1425 (1967); Painter, *Book Review*, 35 GEO. WASH. L. REV. 146 (1966). For a general discussion of the problems of enforcing section 16(b), see Munter, *Section 16(b) of the Securities Exchange Act of 1934: An Alternative to "Burning Down the Barn in Order to Kill the Rats,"* 52 CORNELL L. REV. 69 (1966).

19. Though the corporation will usually bring the suit against the director, any stockholder, after making a proper demand on the corporation, may institute the action whether or not he owned shares at the time of the alleged improper transactions. See R. FROME & V. ROSENZWEIG,

confidential information in making the transactions.²⁰ Judicial interpretation of section 16(b) reflects a gradual evolution from an “objective” standard to a “pragmatic” standard in the application of the statute to the questioned transaction.²¹ Briefly stated,²² the objective analysis requires only a determination of whether a transaction or class of investor is within the scope of section 16(b),²³ while the pragmatic approach, applied to “unorthodox” transactions,²⁴ requires a determination of whether the transaction is of a kind that might give rise to speculative abuse.²⁵ Courts have used the pragmatic test to determine whether specific stock transfers constitute a “purchase” or “sale” under

SALES OF SECURITIES BY CORPORATE INSIDERS 229-30 (2d ed. 1975); 2 L. LOSS, *supra* note 13, at 1045-47.

20. *E.g.*, Booth v. Varian Assocs., 334 F.2d 1, 3 (1st Cir. 1964), *cert. denied*, 379 U.S. 961 (1965); Adler v. Klawans, 267 F.2d 840, 845 (2d Cir. 1959); Prager v. Sylvestri, 449 F. Supp. 425, 429 (S.D.N.Y. 1978); Schur v. Salzman, 365 F. Supp. 725, 728 (S.D.N.Y. 1973); Blau v. Potter, [1973 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,115, at 94,447 (S.D.N.Y. Jan. 18, 1973). Thomas Corcoran, one of the draftsmen of the Securities Exchange Act, explained:

You hold the director, irrespective of any intention or expectation to sell the security within 6 months after, because it will be absolutely impossible to prove the existence of such intention or expectation, and you have to have this crude rule of thumb, because you cannot undertake the burden of having to prove that the director intended, at the time he bought, to get out on a short swing.

Stock Exchange Practices: Hearings on S. 2693 Before the Senate Banking and Currency Committee, 73d Cong., 2d Sess. 6557 (1934), *reprinted in* 6 J. ELLENBERGER & E. MAHAR, *supra* note 15, at Item 22 [hereinafter cited as *Hearings on S.2693*].

21. A considerable amount of scholarly comment on these two standards exists. For some of the better sources, see Hazen, *The New Pragmatism Under Section 16(b) of the Securities Exchange Act*, 54 N.C.L. REV. 1 (1975); Tomlinson, *Section 16(b): A Single Analysis of Purchases and Sales—Merging the Objective and Pragmatic Analyses*, 1981 DUKE L.J. 941; Weinstock, *Section 16(b) and the Doctrine of Speculative Abuse: How to Succeed in Being Subjective Without Really Trying*, 29 BUS. LAW. 1153 (1974); Wentz, *Refining a Crude Rule: The Pragmatic Approach to Section 16(b) of the Securities Exchange Act of 1934*, 70 NW. U.L. REV. 221 (1975); Note, *Insider Liability for Short-Swing Profits: The Substance and Function of the Pragmatic Approach*, 72 MICH. L. REV. 592 (1974); Note, *Reliance Electric and 16(b) Litigation: A Return to the Objective Approach?*, 58 VA. L. REV. 907 (1972) [hereinafter cited as Note, Reliance Electric].

22. A survey of judicial articulation of the objective and pragmatic approaches is beyond the scope of this comment.

23. Note, Reliance Electric, *supra* note 21, at 912. *See, e.g.*, Heli-Coil Corp. v. Webster, 352 F.2d 156, 165 (3d Cir. 1965).

24. This term, used by Professor Loss in 2 L. LOSS, *supra* note 13, at 1069, was adopted by the Supreme Court in Kern County Land Co. v. Occidental Petroleum Corp., 411 U.S. 582, 593 (1973). Among the transactions mentioned by the Court as being unorthodox were stock conversions, exchanges pursuant to mergers, stock reclassifications and dealings in options. *Id.* at n.24 (citing 2 L. LOSS, *supra* note 13, at 1069).

25. Kern County Land Co. v. Occidental Petroleum Corp., 411 U.S. 582, 594-95 (1973); Pet- teys v. Butler, 367 F.2d 528, 535 (8th Cir. 1966), *cert. denied*, 385 U.S. 1006 (1967); Ferraiolo v. Newman, 259 F.2d 342, 344-45 (6th Cir. 1958), *cert. denied*, 359 U.S. 927 (1959); Makofsky v.

section 16(b). They have not found that test useful in determining who is a "beneficial owner."²⁶

The Securities and Exchange Commission has never spoken directly to the question of what constitutes beneficial ownership under section 16(b). Moreover, because the Commission is not responsible for enforcement of the provision, it has consistently refused to issue opinions concerning investors' liability thereunder.²⁷ Thus, in structuring their transactions, insiders can only hope that the federal courts will not void their stock transactions retroactively.²⁸ Several Commission releases, however, have defined the circumstances under which an insider is a beneficial owner subject to the disclosure requirements of section 16(a).²⁹ Moreover, a regulation which sets out those relationships be-

Ultra Dynamics Corp., 383 F. Supp. 631, 637-38 (S.D.N.Y. 1974); Popkin v. Dingman, 366 F. Supp. 534, 538 (S.D.N.Y. 1973).

26. See *infra* note 96 and accompanying text.

27. Thus, for example, the commission refuses to issue no-action letters in the context of section 16(b). "[T]he staff as a matter of policy will not issue no-action letters regarding section 16(b) because the Commission has no enforcement responsibilities under that section. Likewise, . . . the staff will not issue letters which have the effect of interpreting that provision." Letter from Securities and Exchange Commission to Chromalloy American Corp. (May 15, 1980) (available on LEXIS, Fedsec library, Noact file).

28. See Note, "Beneficial Ownership" Under Section 16(b) of the Securities Exchange Act of 1934, 77 COLUM. L. REV. 446, 463 (1977).

29. 15 U.S.C. § 78p(a) (1976). In general terms, this provision of the Act requires corporate insiders to file a statement each month with the Commission indicating any changes in their holdings of the corporation's securities. Intended as another weapon against unfair manipulation, the section aims to "encourage the voluntary maintenance of proper fiduciary standards by those in control of large corporate enterprises whose securities are registered on the public exchanges." H.R. REP. NO. 1383, 73d Cong., 2d Sess. 13, *reprinted in* 5 J. ELLENBERGER & E. MAHAR, *supra* note 15, at Item 18.

One early release under the Act ruled that a trustee who will receive the trust corpus in the event the beneficiary fails to attain a certain age must report the trust's stock transactions under section 16(a). SEC Exchange Act Release No. 1965 (1938), 11 Fed. Reg. 10971 (1946). *But cf.* Cook & Feldman, *supra* note 14, at 385 ("[I]f he has merely a remote contingent interest, there is some difference of opinion as to whether he should report the trust transactions.").

In SEC Exchange Act Release No. 34-7793, 3 FED. SEC. L. REP. (CCH) ¶ 26,031 (Jan. 19, 1966), the Commission opined, "A person also may be regarded as the beneficial owner of securities held in the name of another person, if by reason of any contract, understanding, relationship, agreement, or other arrangement, he obtains therefrom benefits substantially equivalent to those of ownership." A month later, the Commission clarified the scope of this release, stating, "the fact that ownership of securities and transactions in those securities are reported under section 16(a) of the Securities Exchange Act of 1934 does not necessarily mean that liability will result therefrom under section 16(b)." SEC Exchange Act Release No. 34-7824, 3 FED. SEC. L. REP. (CCH) ¶ 26,030 (Feb. 14, 1966).

Recently, in SEC Exchange Act Release No. 34-18114, 3 FED. SEC. L. REP. (CCH) ¶ 26,062 (Sept. 24, 1981), the Commission enumerated some of the generally accepted indicia of beneficial

tween an insider and others that give rise to beneficial ownership under section 16(a) augments these releases.³⁰ Federal courts have only recently begun to look to the disclosure provisions for assistance in answering questions concerning section 16(b).³¹

In *Blau v. Lehman*,³² the Supreme Court rendered its only decision regarding an insider's liability for a related party's profits.³³ The Court held that the plaintiff corporation³⁴ could not recover the entire short-swing profit of a brokerage firm to which one of plaintiff's directors belonged. Rather, the Court limited plaintiff's recovery to the director's proportionate share of the profits.³⁵ Despite the likelihood that its decision would promote the exchange of confidential information among insiders and their partners,³⁶ the Court found sufficient support for its holding in the legislative history of the Securities Exchange Act.³⁷ *Lehman* did not, however, suggest any general standard for de-

ownership. These include (1) the right to vote the shares; (2) the right to control the stock's transfer; (3) the right to control the income from the securities; and (4) the right to control the proceeds in liquidation.

30. 17 C.F.R. § 240.16a-8 (1981). Under the regulation, beneficial ownership includes ownership as a trustee where either the trustee or members of his immediate family, including any stepchildren, have a vested interest in the income or assets of the trust.

31. *See* *Whittaker v. Whittaker Corp.*, 639 F.2d 516 (9th Cir.), *cert. denied*, 454 U.S. 1030 (1981). *Cf.* *Whiting v. Dow Chem. Co.*, 386 F. Supp. 1130, 1137 (S.D.N.Y. 1974), *aff'd*, 523 F.2d 680 (2d Cir. 1975).

32. 368 U.S. 405 (1962). This case is noted in 46 MARQ. L. REV. 246 (1962).

33. *See* Note, *supra* note 28, at 452.

34. The suit was brought derivatively on behalf of the corporation.

35. 368 U.S. at 413-14. The Court conceded that the partnership might function as an insider where it deputizes one of its partners, himself an insider, to act for the partnership. *Id.* at 409-10. *See generally* W. PAINTER, *supra* note 8, at 53-96. In *Lehman*, the court of appeals permitted the corporation to recover the insider's share of the profits even though he had disclaimed them. *Blau v. Lehman*, 286 F.2d 786, 791 (2d Cir. 1960), *aff'd*, 368 U.S. 403 (1962).

36. 368 U.S. at 414 (Douglas, J., dissenting). *See also* *Blau v. Lehman*, 286 F.2d at 799 (Clark, Circuit Justice, dissenting).

37. The original House and Senate bills contained a section which would have rendered any recipient of inside information liable for his short-swing profits. The provision read, in pertinent part: "Any profit made by any person, to whom such unlawful disclosure shall have been made, in respect of any transaction or transactions in such registered security within a period not exceeding six months after such disclosure shall inure to and be recoverable by the issuer . . ." S. 2693, 73d Cong., 2d Sess. § 15(b)(3) (1934), *reprinted in* 11 J. ELLENBERGER & E. MAHAR, *supra* note 15, at Item 34; H.R. 7852, 73d Cong., 2d Sess. § 15(b)(3) (1934), *reprinted in* 10 J. ELLENBERGER & E. MAHAR, *supra* note 15, at Item 24. Thus, the *Lehman* Court concluded that Congress' failure to enact the provision was persuasive against allowing recovery of the profits of the corporate insider's partners. 368 U.S. at 411-12. *But see supra* note 35.

The same House bill had an analogous provision which would have attributed the stock of an insider's spouse, child, parent or trustee to the insider. A defendant could avoid this attribution by

termining under what circumstances a particular relationship between an insider and one to whom short-swing profits accrue might give rise to section 16(b) liability.

The issue of insider liability for a spouse's profits arose tangentially in *Jefferson Lake Sulphur Co. v. Walet*.³⁸ The defendant, a corporate director, argued that half of the profits had accrued to his wife under Louisiana's community property law. The district court rejected this argument and granted the corporation full recovery, observing that the insider would otherwise have a one-half undivided interest in any unrecovered profits.³⁹ While admitting that its decision might conflict with Louisiana community property law, the court held that the federal policy embodied in the Securities Exchange Act prevailed.⁴⁰

In *Marquette Cement Mfg. Co. v. Andreas*,⁴¹ the defendant director was the sole trustee of nineteen trusts which had realized short-swing profits as a result of a merger of two corporations. After the merger, the new corporation sued to recover the profits of all of the trusts.⁴² The district court refused to hold the insider liable, pointing out that he had no power to revoke any of the trusts, except for his own.⁴³ Thus, the plaintiff corporation recovered only the profit of the trust of which the defendant was the beneficiary.⁴⁴

In *Blau v. Potter*,⁴⁵ the District Court for the Southern District of New York confronted a slightly different issue: whether the transactions of a corporate insider and his wife could be considered together in

sustaining the burden of showing that he neither approved of the transaction nor attempted to evade any of the act's provisions. H.R. 7852, 73d Cong., 2d Sess. § 19(d) (1934), reprinted in 10 J. ELLENBERGER & E. MAHAR, *supra* note 15, at Item 24.

38. 104 F. Supp. 20 (E.D. La. 1952), *aff'd*, 202 F.2d 433 (5th Cir.), *cert denied*, 346 U.S. 820 (1953).

39. *Id.* at 25.

40. *Id.*

41. 239 F. Supp. 962 (S.D.N.Y. 1965).

42. The beneficiaries of these trusts consisted largely of members of the defendant's family, *id.* at 965, including his ex-wife. *Id.* at 967.

43. *Id.*

44. As to the familial relation, the court said, "Whether [defendant] held a beneficial interest in that stock is a question of fact to be determined from all the evidence. Of course, he had the normal interest in seeing that members of his family were well and comfortable, but this does not come within the Section 16(b) definition of 'any profit realized by him.'" 239 F. Supp. at 967 (quoting *Blau v. Lehman*, 368 U.S. 403, 414 (1962)). However, the court apparently acknowledged the potential liability of the defendant for the profits of the other trusts: "The plaintiff does not present any substantial evidence that the trust beneficiaries received trust proceeds in lieu of support from the defendant." *Id.*

45. [1973 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,115 (S.D.N.Y. Jan. 18, 1973).

determining liability under section 16(b).⁴⁶ According to the testimony, the wife maintained her own brokerage account, kept her funds separate from those of her husband, did not consult her husband on the purchases at issue or any other purchases, and contributed no money for household or personal expenses.⁴⁷ Faced with this un rebutted evidence, the court refused to treat the wife's purchase and the husband's subsequent sale as a single impermissible short-swing transaction.⁴⁸

In *Whiting v. Dow Chemical Co.*,⁴⁹ however, the Second Circuit Court of Appeals treated the wife's sale of stock and her husband's subsequent exercise of an option to purchase⁵⁰ as one transaction, holding the insider husband liable to the corporation for the loss avoided when the stock price dropped. Although the husband and wife kept their respective stock holdings segregated, the evidence revealed that the two filed joint tax returns, used the same financial advisors, and consulted each other concerning financial matters. Furthermore, the wife's dividend income from her considerable stock holdings went to provide for various family expenses.⁵¹ The Second Circuit held that an insider beneficially owns the stock holdings of his spouse where the ordinary rewards of stock ownership are used for their joint benefit.⁵²

46. Between November of 1966 and January of 1977, the defendant's wife bought 2800 shares of stock in the plaintiff corporation. "Less than six months later, [the defendant] sold 22,400 shares" at a higher price. *Id.* at 94,476. The plaintiff sought to have the court treat the transactions as if one person, the defendant insider, had effected both of them. The court's resolution of the issue turned on a determination of whether the defendant beneficially owned his wife's stock for the purpose of section 16(b). *Id.*

47. *Id.* at 94,477. As one commentator has pointed out, this case involves "an extreme set of facts." Note, *supra* note 28, at 454.

48. "[T]he uncontroverted testimony in this case clearly establishes that no benefit has inured to Mr. Potter from the securities purchased by his wife. Under these circumstances, I decline to attribute those purchases to him." [1973 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,115, at 94,478. *Cf.* B.T. Babbitt, Inc. v. Lachner, 332 F.2d 255, 257 (2d Cir. 1976) (parties stipulated that wife's stock was attributable to her insider spouse); Schur v. Salzman, 365 F. Supp. 725, 732 (S.D.N.Y. 1973) (officer-director held to be beneficial owner of shares purchased with funds from joint bank account with wife).

49. 523 F.2d 680 (2d Cir. 1975).

50. *Id.* at 682. Interestingly, the defendant insider used funds borrowed from his wife to exercise the purchase option.

51. *Id.* "[W]hile they continue to live as a married couple, there is hardly anything Mrs. Whiting gets out of the ownership that her [her husband] does not share." *Id.* at 688.

52. *Id.* These "rewards of ownership" include dividend income, capital gains, and "the power to dispose of the shares" to one's children by gift or by testament. *Id.* See also Note, *Securities Law—Insider Liability Under Section 16(b) of the Securities Exchange Act of 1934—Whiting v. Dow Chemical Co.*, 17 B.C. INDUS. & COM. L. REV. 627 (1976); 2 J. Corp. L. 188 (1976).

Applying this standard, the court of appeals found sufficient evidence of such joint benefit to sustain the district court's judgment for the plaintiff corporation.

The decision in *Altamil Corp. v. Pryor*⁵³ further expanded the scope of section 16(b) liability by attributing the wife's short-swing transactions to her husband, a director of the plaintiff corporation, even though the wife kept the proceeds in a separate account and did not use them to support herself or her husband or to pay household obligations.⁵⁴ Admitting that the *Whiting* "joint benefit" standard could not be applied, the district court adopted a "control" test. Under this approach, an insider who can exercise complete control over his spouse's stock transactions so as to increase her individual estate acts as a beneficial owner of the spouse's stock.⁵⁵ The court ruled that the benefit received by the insider consisted of a diminished need to make taxable transfers to his wife.⁵⁶

Whittaker v. Whittaker Corp.,⁵⁷ a recent case from the Ninth Circuit, involved the liability of an insider for the short-swing profits of his mother, who had granted him a general power of attorney over her affairs.⁵⁸ The court justified its finding against the director on two distinct grounds. First, the insider exercised control over the securities

53. 405 F. Supp. 1222 (S.D. Ind. 1975).

54. *Id.* at 1225.

55. *Id.* at 1226. *Cf.* *Blau v. Mission Corp.*, 212 F.2d 77, 80 (2d Cir.), *cert. denied*, 347 U.S. 1016 (1954) (control of an insider corporation gives the controlling entity insider status).

56. *Id.* at 1225. The evidence showed that the defendant had in the past made such transfers to his wife. *Id.* at 1225-26. *Cf.* *J.P. Morgan & Co.*, 10 S.E.C. 119 (1941), in which the SEC recognized the pecuniary interest of a father in his adult daughter's stock. The issue in the case was whether the father was disqualified from serving as an indenture trustee for certain securities by reason of his daughter's ownership of over ten percent of a class of the underwriter's stock. In holding that the father was the beneficial owner of his daughter's shares, and thus ineligible under the Trust Indenture Act of 1939 § 310(b)(6)(B), 15 U.S.C. § 77jjj(b)(6)(B) (1976), the Commission noted:

[N]early \$200,000 par value of the stock yielding nearly \$8,000 per year is held by Leffingwell's daughter. Leffingwell testified that he gave it to her, not only to divest himself of its ownership but also in order to capitalize an allowance he had been giving to her. He further testified that she had four children and needed the income. It may be true that a man is not generally responsible for the support of his grown daughter or his grandchildren, and it may be that if anything occurred to stop the income on that investment, Leffingwell could wash his hands of the whole matter and suffer no loss as a matter of law. But to say that his daughter's interest in that investment is of no pecuniary interest to him is to ignore realities.

10 S.E.C. at 147.

57. 639 F.2d 516 (9th Cir.), *cert denied*, 454 U.S. 1030 (1981).

58. *Id.* at 523.

and possessed an unrestricted ability to use the proceeds. This indicated that the short-swing gain came within the language "profit realized by him" of section 16(b).⁵⁹ Second, the director satisfied the requirements of beneficial ownership under section 16(a)⁶⁰ and received sufficient actual rewards of ownership to warrant attributing his mother's stock to him for purposes of section 16(b).⁶¹ Thus, the decision reflected elements of both the *Altamil* "control" approach and the *Whiting* "rewards of ownership" test.

In *CBI Industries, Inc. v. Horton*,⁶² the Seventh Circuit Court of Appeals invoked a new standard for determining section 16(b) liability, holding that "profit realized by him" encompasses only direct pecuniary benefits.⁶³ Circuit Judge Posner, writing for the court, began by determining the nature and amount of gain, if any, which the defendant Horton realized from the contested sale and purchase. Had Horton subsequently bought shares for his own account, he clearly would have violated section 16(b).⁶⁴ Because the defendant purchased shares for his sons' trusts, however, the court had to face the issue of whether he had realized any profit which the plaintiff corporation could recover under that section.⁶⁵ Judge Posner pointed out that Horton had a general power to manage the trusts, but could not divert their income to

59. *Id.* at 523-24. The evidence showed that the insider controlled his mother's investments in corporate securities, determined the timing of her stock purchases, and used her assets to fund advantageous investment opportunities. *Id.* As of 1973, the director owed his mother over \$700,000, according to the district court. *Whittaker v. Whittaker Corp.*, [1977-78 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 96,008, at 91,529 (C.D. Cal. Mar. 22, 1977).

60. While admitting that the Commission's views in Release No. 7793, *supra* note 29, apply to beneficial ownership under the reporting requirements of section 16(a), the court ruled "[I]t is not far-fetched similarly to determine by reference to § 16(a) what stock those insiders own for § 16(b) liability." 639 F.2d at 525. See also *Lewis v. Varnes*, 505 F.2d 785, 788 (2d Cir. 1974); *Feder v. Martin Marietta Corp.*, 406 F.2d 260, 268 (2d Cir. 1969), *cert denied*, 396 U.S. 1036 (1970).

61. 639 F.2d at 526.

62. 682 F.2d 643 (7th Cir. 1982).

63. *Id.* at 646.

64. *Id.* at 644.

65. The court assumed that the trusts had realized gain from the purchase of stock at a lower price than that which Horton had received upon the prior sale of his own stock. *Id.* Thus, the court reduced the ultimate issue to whether the trusts' gains were attributable to Horton. Judge Posner did not discuss a possible alternative holding—that neither Horton nor the trusts had realized any gain, since the transactions were made through separate accounts. Such a holding would in any event be unsatisfactory because, for example, an insider might shield himself from section 16(b) liability by maintaining separate accounts for himself and his wife, a device disapproved in the *Whiting* case. See *supra* notes 49-52 and accompanying text.

for his own use.⁶⁶ Horton would receive money from the trusts only upon the death of both sons without issue before the sons reached twenty-five years of age.⁶⁷ This contingent remainder interest, the court held, was too remote to warrant attribution of the repurchased shares to Horton as the beneficial owner.⁶⁸ Judge Posner thus concluded that the instant case was distinguishable from *Whiting* and *Whittaker*, where the corporate insiders had direct access to the proceeds of the short-swing transactions.⁶⁹

The court conceded that the defendant may have realized some non-pecuniary or indirect benefit from the transactions. An improvement in his sons' financial positions probably provided Horton with an enhanced sense of well-being.⁷⁰ Also, any gain realized by the trusts would reduce the need for Horton to make taxable transfers to his sons.⁷¹ The court ruled, however, that neither of these two benefits constituted profit under section 16(b). As to the former, the court was not inclined to determine that the 1934 Congress intended to make emotional enrichment recoverable by a plaintiff corporation.⁷² As to the latter, the court explicitly rejected the *Altamil*⁷³ holding that such a saving to the insider by way of reduced taxable transfers results in section 16(b) liability.⁷⁴ Judge Posner also argued that policy considerations supported the court's refusal to hold Horton liable on the basis of these benefits. A finding of liability, he suggested, would have undesirable consequences for the management of stock portfolios by insiders⁷⁵

66. *Id.* at 645.

67. *Id.*

68. *Id.* The court suggested that multiplying the probability of such a joint death by the amount in controversy would yield the expected value to the defendant of the trust profits. This amount would be de minimis, contended Judge Posner, and the plaintiff would not bother to sue unless some other ground of recovery were present. *Id.*

69. *Id.*

70. "A person's 'wealth,' in a realistic though not pecuniary sense, is increased by increasing the pecuniary wealth of his children . . . provided only that he has the normal human feelings toward his children." *Id.* at 646.

71. *Id.*

72. "But taking a 'realistic' approach to the interpretation of ['profit realized by him'] would result in placing greater restrictions on corporate insiders than Congress can plausibly be thought to have intended in 1934, when notions of conflict of interest were less exacting than they are today." *Id.*

73. See *supra* text accompanying note 56. Cf. *Marquette Cement Mfg. Co. v. Andreas*, 239 F. Supp. 962, 967, quoted *supra* note 44.

74. 682 F.2d at 646. The *Horton* court did not, however, rule that *Altamil* would have been decided differently under the new test.

75. "Thus the implication of holding Horton liable in this case would be that neither he nor

and for the enforcement of section 16(b) by the federal courts.⁷⁶

The plaintiff in *Horton* also contended that "beneficial ownership" for purposes of section 16(b) should be determined with reference to the regulation governing the section 16(a) reporting requirements.⁷⁷ Rejecting this argument, the court stated that Horton was an insider by reason of his status as a director, not as a beneficial owner of ten percent of a class of equity securities.⁷⁸ On this point, Circuit Judge Wood dissented from the court's opinion, arguing that the regulation sheds at least some light on the meaning of section 16(b).⁷⁹

An examination of federal court decisions that have construed the phrases "beneficial owner" and "profit realized by him" reveals that the *Horton* court had a number of standards from which to choose in deciding whether to hold the defendant liable to the corporation. While the *Marquette*⁸⁰ court laid down no specific test for determining whether a benefit constitutes recoverable profit, it clearly indicated that

any corporate insider could manage or control . . . an investment portfolio containing the stock of his company without being in jeopardy of violating section 16(b)." *Id.*

76. "Though some economists believe that emotional relationships within the family can be expressed in economic terms . . . we doubt that the framers of section 16(b) would have wanted to complicate enforcement of the statute to this degree merely to make an already Draconian strict liability statute still more Draconian. It would be only a little simpler to determine the effect of the trust's profit on Horton's gift-giving to his sons." *Id.* at 647.

77. 17 C.F.R. § 240.16a-8(a) provides, "Beneficial ownership of a security for the purpose of section 16(a) shall include: (1) The ownership of securities as a trustee where either the trustee or members of his immediate family have a vested interest in the income or corpus of the trust . . ." Sons and daughters of the trustee are members of his immediate family, regardless of their dependency status. *Id.* at § 240.16a-8(3)(1).

78. 682 F.2d at 646. Note that section 16(a) refers twice to beneficial ownership. The relevant text reads:

Every person who is directly or indirectly the *beneficial owner* of more than 10 per centum of any class of any equity security . . . or who is a director or an officer of the issuer of such security, shall file . . . a statement with the Commission . . . of the amount of all equity securities of such issuer of which he is the *beneficial owner* . . .

15 U.S.C. § 78p(a) (emphasis added). The first reference to beneficial ownership defines a class of individuals who are insiders subject to the disclosure provisions. The second instance relates to those transactions an insider must disclose. See *supra* note 9 (regarding the role of beneficial ownership in § 16(b) litigation). Clearly, all insiders must disclose changes in ownership of the shares which they beneficially own. See *Whittaker v. Whittaker Corp.*, 639 F.2d 516, 525 (9th Cir.), *cert. denied*, 454 U.S. 1030 (1981). Thus, the definition of beneficial ownership in Regulation 16a-8, *supra* note 77, should apply to all insiders, not just those who are insiders by virtue of beneficially owning 10% of a class of stock. See *SEC v. Golconda Mining Corp.*, 291 F. Supp. 125, 127 (S.D.N.Y. 1968) (director held to have violated the regulation). The *Horton* court's contention that Regulation 16a-8 would not apply to an officer or director is simply incorrect.

79. 682 F.2d at 647-48.

80. *Marquette Cement Mfg. Co. v. Andreas*, 239 F. Supp. 962 (S.D.N.Y. 1965).

an insider's interest in securing his family's prosperity is not such a benefit.⁸¹ The *Whiting*⁸² test, if applied to the facts in *Horton*, would have resulted in section 16(b) liability if the plaintiff had shown that the rewards of stock ownership jointly benefited both the defendant and the trust beneficiaries.⁸³ Under the *Altamil* standard,⁸⁴ liability would depend on whether the trustee exercised control over the trusts' stock to such an extent that he could increase his sons' wealth through short-swing transactions and thereby reduce the necessity of using his own funds to support them.⁸⁵ Finally, under the two approaches set out in *Whittaker*,⁸⁶ the defendant Horton could have been held liable either by reason of his ability to exercise control over the trust securities and their proceeds,⁸⁷ or by reason of a requirement that he disclose the transactions under section 16(a).⁸⁸ Faced with this wide range of standards, the Seventh Circuit chose to formulate a new test, namely, whether the insider received a direct pecuniary benefit⁸⁹ from the transaction.⁹⁰

In section 16(b) cases, courts have struggled to find some balance between the clear congressional desire to curb trading on inside information⁹¹ and the crude statutory provision⁹² that only weakly reflects this aim.⁹³ The *Horton* case represents this same tension. On the one hand, compliance with the clear legislative purpose of discouraging short-swing trading argues for imposing liability on an insider trustee who uses confidential information to increase the wealth of his family members, the trust beneficiaries. On the other hand, Congress' failure to give the corporation a cause of action against a non-insider who trades on inside information militates against trustee liability, where the trustee cannot control the disposition of the profit.

81. See *supra* note 44.

82. *Whiting v. Dow Chem. Co.*, 523 F.2d 680 (2d Cir. 1975).

83. See *supra* notes 49-52 and accompanying text.

84. *Altamil Corp. v. Pryor*, 405 F. Supp. 1222 (S.D. Ind. 1975).

85. See *supra* notes 53-56 and accompanying text.

86. *Whittaker v. Whittaker Corp.*, 639 F.2d 516 (9th Cir.), *cert. denied*, 454 U.S. 1030 (1981).

87. See *supra* note 59 and accompanying text.

88. See *supra* note 60 and accompanying text.

89. This standard was recommended in Note, *supra* note 28, at 461.

90. See *supra* text accompanying note 63.

91. See *supra* notes 15-17 and accompanying text.

92. See *Hearings on S.2693, supra* note 20, at 6557 (statement of Thomas Corcoran).

93. For example, if Congress had truly wanted to discourage short-swing trading, it should not have excluded recipients of confidential information from the Act's coverage. See *supra* note 37.

When first confronted with the issue and the court's reasoning, it is difficult to disagree with the Seventh Circuit's decision in *Horton*. As Circuit Judge Wood indicates, the case poses "a very close question."⁹⁴ However, the court could have approached the problem by considering whether the relationship of the trustee to the trust beneficiaries could increase the possibility of speculative abuse. Courts have frequently used this so-called "pragmatic" test to determine whether a transfer of stock is a sale or purchase.⁹⁵ Courts have not used this test to ascertain whether a third person's gain should be attributed to the insider under section 16(b), although the *Whittaker* court paid lip service to it.⁹⁶ Assuming a set of facts such as those in *Horton*, it is possible that a corporate insider might wish to trade in his own company's shares for the benefit of family members to whom he would otherwise give financial support.⁹⁷

Admittedly, section 16(b) does not generally impose liability on non-insiders who trade on the basis of confidential information received from an insider.⁹⁸ The section, however, does not apply solely to the insider. For example, if the trust beneficiaries in *Horton* had been the wife or minor children of the insider, the court probably would have attributed the trust profits to the trustee. The inquiry should focus on whether the relationship between the insider and the "direct" beneficiary is of such a nature that the former will be likely to satisfy his voluntarily assumed duties by engaging in speculative trading. If so, liability should be imposed. The *Horton* court justifiably expresses concern over how to limit an "indirect benefit" standard such as that set out in *Altamil*.⁹⁹ It may not be feasible for courts to create immutable principles to govern corporate insiders who effect a savings for their family members via short-swing transactions. However, courts could conceiv-

94. 682 F.2d at 647.

95. See text and cases cited *supra* note 25 for a description of the pragmatic approach to defining sale and purchase.

96. The court in *Whittaker* mentioned the trend toward a pragmatic application of section 16(b), but did not tie the pragmatic analysis to its discussion of beneficial ownership. *Whittaker v. Whittaker Corp.*, 639 F.2d 516, 522, 525-27 (9th Cir.), *cert. denied*, 454 U.S. 1030 (1981). In the other beneficial ownership cases discussed *supra* in the text accompanying notes 32-61, the courts did not mention the pragmatic approach. See also *Altamil Corp. v. Pryor*, 405 F. Supp. 1222, 1224 (S.D. Ind. 1975) ("[T]he rule is an objective one . . .").

97. For example, in *Horton* the defendant provided full financial support to one of his sons, 530 F. Supp. at 786, a fact which the Seventh Circuit conveniently ignored.

98. See *supra* note 37.

99. 682 F.2d at 646.

ably hold that certain relationships, such as parent-adult child, give rise to a rebuttable presumption¹⁰⁰ that the insider has realized a recoverable saving. Such an approach seems consistent with the view that the statute must be liberally construed to accomplish the express policy of the legislature.¹⁰¹

The *Horton* test represents a slight retreat from the expansion of the scope of section 16(b) liability. In future cases, plaintiffs are likely to find it more difficult to recover short-swing profits from a corporate insider who permits the members of his immediate family to share in the advantages of access to confidential corporate information. If the insider retains no control over the profits and receives no "direct benefit" from them, he may effect transfers to members of his family and realize a substantial savings on his out-of-pocket expenses, yet escape liability to the corporation.¹⁰²

By holding that a corporate insider must receive a direct pecuniary benefit from a short-swing transaction in order for the corporation to recover profit under section 16(b) of the Securities Exchange Act, the Seventh Circuit has made it possible for insiders to use confidential information for the benefit of their family members through the use of a trust device. This decision seems likely to increase the occurrences of speculative trading by those privy to corporate secrets.

R.E.H.

100 *Cf. supra* notes 45-48 and accompanying text for an example of a corporate insider who successfully rebutted a presumption that his wife's short-swing profits could be attributed to him.

101. *See, e.g.,* *Petteys v. Butler*, 367 F.2d 528, 532 (8th Cir. 1966), *cert. denied*, 385 U.S. 1006 (1967).

102. The *Horton* court implied that it would have held the defendant liable if he had been legally obliged to support his two sons. 682 F.2d at 645. Also, the court's "direct pecuniary benefit" standard would logically apply where both the sale and purchase of shares were made through a trust account. The implication is that a corporate insider will not be liable under section 16(b) if he sets up irrevocable trusts for his non-dependent family members and carries on short-swing trading in his capacity as trustee.