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mon law tort of interference with a prospective economic advantage. The court of appeals concluded from the existence of this cause of action at state law that Congress would have announced explicitly an intention to grant a private remedy to offerors had it so intended.[120] The Supreme Court, however, used the existence of the state cause of action to infer that if Congress had intended to create a duplicate federal remedy, it would have stated that intention clearly.[121] Similarly, in *Santa Fe Industries, Inc. v. Green,*[122] the Court stated that in the absence of a clear command from Congress, it would hesitate to override established state policies of corporate law.[123] This rationale is also the moving force behind the holding in *Piper.* The Court would not assume that Congress intended offerors to have a damage remedy unless that remedy was essential to accomplishment of the statutory purpose. In the future, those who seek expansion of federal securities laws will have to look to Congress, not to the Supreme Court.[124]

SCOTT HAMILTON

V. SECTION 16(b)

The primary objective of the Securities Exchange Act of 1934 ('34 Act) is to provide a free and open market for trading securities with all traders having access to the same relevant market information.[1]

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[120] 480 F.2d at 360-61; *see* note 96 *supra.*

[121] Professor Loss, in a discussion of implied private rights of action under § 14(a), states that statutory silence neither supports nor detracts from the proposition that there should be a private remedy under the '34 Act. 2 L. LOSS, SECURITIES REGULATION 942 (2d ed. 1961).

[122] 97 S. Ct. 1292 (1977).

[123] *Id.* at 1303-04.

[124] In *Green, id.* at 1304, the Court cites Cary, *Federalism and Corporate Law: Reflections Upon Delaware,* 83 YALE L.J. 663, 700 (1974). Professor Cary takes the position that federal regulation of corporate fairness and fiduciary duties cannot be achieved through the vehicle of rule 10b-5. Rather, he advocates federal legislation as a "counterattack against the erosion of standards" brought about by the economic benefits available to states with lenient corporation laws. *Id.*

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[1] 15 U.S.C. § 78a-78hh (1970) *as amended* 15 U.S.C. § 78b-78kk (Supp. V 1975) ('34 Act). *See generally* Yourd, *Trading Securities by Directors, Officers and Stockholders: Section 16 of the Securities Exchange Act,* 38 MICH. L. REV. 133 (1939). The Securities Act Amendments of 1975 reiterate the objective of a free and open market for trading securities. 15 U.S.C. § 78b (Supp. V 1975). The Amendments declare that

Congress, recognizing the easy access of corporate officers, directors and substantial stockholders to a corporation's confidential information, enacted section 16(b) of the '34 Act to insure that these corporate insiders would not take personal advantage of such inside information.[2] This section provides for recovery by the corporation of all profits realized by insiders on purchases and sales of their corporation's securities made within a six month period, commonly referred to as short swing trading.[3]

Originally, federal courts applied the statute mechanically, and held insiders strictly liable for all short swing profits regardless of any possibility for speculative abuse.[4] This strict liability[5] approach pre-

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securities markets are a national asset and that it is in the national interest to protect investors through the maintenance of fair and orderly markets. 15 U.S.C. § 78k-1 (Supp. V 1975).

[2] 15 U.S.C. § 78p(b)(1970). *See, e.g.,* Adler v. Klawans, 267 F.2d 840, 844 (2d Cir. 1959). *See generally* Note, *Extraterritorial Application of Section 16(b) of the Securities Exchange Act of 1934,* 32 WASH. & LEE L. REV. 699, 708-10 (1975).

[3] 15 U.S.C. § 78p(b) provides:

> 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 . . . shall inure to and be recovered by the issuer, irrespective of any intention on the part of such beneficial owner, director or officer. . . .

A beneficial owner under the '34 Act is any person who directly or indirectly owns more than 10% any class of a corporation's equity securities. *Id.* § 78p(a). The term equity security is broadly defined in the '34 Act to include any stock or similar security and securities or warrants which carry with them the right to convert or purchase a stock or similar security. *Id.* § 78c(11). The Securities Exchange Commission is given discretion to promulgate rules and regulations concerning the securities which it deems an equity security. *Id.*

[4] *See, e.g.,* Park & Tilford, Inc. v. Schulte, 160 F.2d 984 (2d Cir.), *cert. denied,* 332 U.S. 761 (1947). In *Park & Tilford,* three controlling owners of a company converted preferred shares to common shares because the corporation had ordered an automatic redemption of all preferred shares at an exchange value below that of voluntary conversion. The court mechanically held that this exchange constituted a purchase since before the conversion the insiders owned no common stock while after the conversion they did. When this common stock was sold within six months, the court held the three statutory insiders liable under § 16(b) without full inquiry into any mitigation of the possibility of insider abuse caused by this economically forced conversion. *See also* Smolowe v. Delendo Corp., 136 F.2d 231 (2d Cir.), *cert. denied,* 320 U.S. 751 (1943). *See generally* Wentz, *Refining A Crude Rule: The Pragmatic Approach of Section 16(b) of the Securities Exchange Act of 1934,* 70 NW. U.L. REV. 221, 225 (1975) [hereinafter cited as Wentz].

[5] Hearings prior to the adoption of § 16(b) described the provision as a "crude rule

sumed that statutory insiders had access to confidential market information[6] and that they had misused the information if they profited on short swing transactions.[7] The Supreme Court in *Kern County Land Co. v. Occidental Petroleum Corp.*,[8] however, held that certain "unorthodox" transactions[9] warranted a more flexible analysis than traditional cash-for-stock transactions.[10] The Court stated that profits realized on unorthodox transactions should not automatically trigger 16(b) liability; in such instances, the courts should determine

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of thumb" designed to prevent insiders from realizing profits on inside information. *Hearings Before the Senate Comm. On Banking and Currency*, 73d Cong., 2d Sess. 6557 (1934)(Statement of Thomas Corcoran). *See* Newmark v. RKO General, Inc., 425 F.2d 348, 350 n.2 (2d Cir. 1970). Section 16(b) has been described as "a hatchet, not a scalpel," since it requires removal of all profits regardless of proof of any actual insider abuse. McElroy, *Pragmatic Disgorging of Insider Profits: A Review of Cases Reported Under Section 16(b)*, 7 ST. MARY'S L.J. 473 (1975). *See* Bershad v. McDonough, 428 F.2d 693, 696 (7th Cir. 1970), *cert. denied*, 400 U.S. 992 (1971).

[6] *See* Foremost-McKesson Inc. v. Provident Securities Co., 423 U.S. 232, 245 (1976); Park & Tilford, Inc. v. Schulte, 160 F.2d 984 (3d Cir. 1947), Smolowe v. Delendo Corp., 136 F.2d 231 (2d Cir. 1943).

[7] Provident Securities Co. v. Foremost-McKesson, Inc., 506 F.2d 601, 611 (9th Cir. 1974), *aff'd* 423 U.S. 232 (1976).

[8] 411 U.S. 582 (1973).

[9] Unorthodox transactions were defined by the *Kern* Court as those transactions "not ordinarily deemed a sale or purchase" of securities, such as "stock conversions, exchanges pursuant to mergers and other corporate reorganizations, stock reclassifications, dealings in options, rights and warrants." *Id.* at 593 n.24, 594. *But cf.* Allis-Chalmers Mfg. Co. v. Gulf & W. Indus., Inc., 527 F.2d 335, 351 (7th Cir. 1975), *cert. denied*, 424 U.S. 928 (1976) (use by purchaser of warrants as consideration for stock purchases was a substitute for cash and demanded a forfeiture of short swing profits under § 16(b)).

[10] 411 U.S. at 593-96. In *Kern*, Occidential Petroleum attempted a takeover of Kern by a tender offer to Kern's shareholders. The tender offer failed when Kern defensively merged with Tenneco Corporation. Occidential had become a ten percent beneficial owner of Kern in May, 1967 and had made purchases of Kern stock in June, 1967. Seeking to rid itself of the Tenneco preferred stock which it would receive pursuant to the Kern-Tenneco merger agreement exchange, Occidential granted Tenneco an option which became irrevocable in August, 1967 and exercisable December 9, 1967 to purchase its Tenneco shares six months and one day after Occidential's last purchase of *Kern* stock. The *Kern* Court found no § 16(b) liability because Occidential lacked access to inside information due to its hostile relationship with the Kern management and because it lacked over the merger negotiations which had dictated the conversion of Kern common shares into Tenneco preferred shares. *See generally* Lang & Katz, *Section 16(b) and "Extraordinary" Transactions: Corporate Reorganizations and Stock Options*, 49 NOTRE DAME LAW. 705 (1974); Wentz, *supra* note 4 at 237-39; Note, *Section 16(b) Liability for Profits Realized From a Cash Purchase and Sale Within Six Months of the Securities of Two Insiders Involved in an Intervening Reorganization*, 75 COLUM. L. REV. 1323 (1975).

whether the transaction was, in actuality, one which gave rise to possible misuse of inside information.[11] This determination was based on a two part inquiry concerning whether the statutory insider had access to inside information and, if so, whether he had sufficient control over the transaction to enable abusive trading.[12] Recent section 16(b) litigation has focused on the identification of unorthodox transactions and the application of the *Kern* Court's liberalizing two pronged test.

In *Rosen v. Drisler*[13] and *Freedman v. Barrow*,[14] plaintiffs, corporate stockholders suing derivatively, challenged stock appreciative rights (SARs) as per se violations of section 16(b). An SAR grants persons possessing a stock option[15] the right to surrender the option to the corporation in exchange for cash or securities or a combination thereof equal to the increased value of the option on the date the SAR is exercised.[16] The plaintiffs contended that SAR transactions represented an exercise of this option,[17] followed by a simultaneous sale of

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[11] 411 U.S. at 595. *See* Ferraiolo v. Newman, 259 F.2d 342, 345 (6th Cir. 1958), *cert. denied*, 359 U.S. 927 (1959).

[12] 411 U.S. at 598-600.

[13] 421 F. Supp. 1282 (S.D.N.Y. 1976).

[14] [1976-1977 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 95,754 (S.D.N.Y. Nov. 4, 1976).

[15] A stock option is a contract made by a corporation with an individual extending an irrevocable offer to purchase stocks for a stipulated period and price. An option is generally distinguishable from a warrant, *see* note 37 *infra*, in that an option is usually non-transferable and is usually attached to either preferred shares or a debt security. Z. CAVITCH, 4A BUSINESS ORGANIZATIONS § 92,021 (Cum. Supp. 1976).

[16] 42 Fed. Reg. 754, 755 (1977), *to be codified in* 17 C.F.R. § 240.16b-3. The purposes for the SAR transactions varied greatly in *Rosen* and *Freedman*. In *Rosen*, the management sought to remove three corporate officers from key roles within the corporation. Each of these officers had options to purchase substantial blocks of the corporation's common stock. To prevent these officers from obtaining this proprietary interest, the corporation negotiated an SAR type transaction where each officer received a cash settlement approximating the spread between the option price and the current market price for a common share. 421 F. Supp. at 1284.

In *Freedman*, the SAR was used as a portion of Exxon Corporation's executive incentive program. Exxon and other large U.S. corporations had initiated programs where options were issued to executives to allow them to participate in the profits of the corporation. To take advantage of this opportunity, the executives borrowed money at interest rates below the expected dividend rate of the corporate stock hoping to exercise these options later and realize a portion of the profit of the corporation. Because of the drastic rise in interest rates in 1971-1974, Exxon adopted the SAR to relieve employees from borrowing money at high rates in order to enjoy the benefits of their option rights. [1976-1977 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 95,754 at 90,711.

[17] Exercise of an option qualifies as a § 16(b) purchase of securities. *See* Keller

securities with the cash or stock settlement representing the short swing profit realized in the transaction.[18]

Utilizing different rationales, the *Rosen* and *Freedman* courts both held that no section 16(b) liability attached to these SAR transactions.[19] The *Rosen* court accepted the plaintiff's argument that an SAR amounted to an exercise of an option and simultaneous sale, but, applying the *Kern* two pronged test,[20] found that the simultaneous nature of the purchase and sale provided no time span for short

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Indus., Inc. v. Walden, 462 F.2d 388 (5th Cir. 1972)(exercise of option presents all the indicia of an outright purchase of securities). Stock options are equity securities and, therefore, any purchase or sale of an option is included within the § 16(b) six month restriction on insider trading. *See* note 3 *supra.* SEC Rule 16b-3, however, exempts from § 16(b) liability any acquisition of stock pursuant to a stock bonus plan and any acquisition of stock options pursuant to a stock option plan. 17 C.F.R. § 240.16b-3 (1976). The rule, however, does not exempt the acquisition of *stock* upon the exercise of an *option. Id.*

[18] Rosen v. Drisler, 421 F. Supp. 1282, 1284 (S.D.N.Y. 1976); Freedman v. Barrow, [1976-1977 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 95,754 at 90,712 (S.D.N.Y. Nov. 4, 1976). In *Freedman,* the plaintiff also premised liability on the theory that an insider SAR transaction equaled an exercise of a stock option coupled with an immediate sale of a portion of the stock acquired to cover out of pocket expenses. [1976-1977 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 95,754 at 90,713. Any statutory insider who exercised options and immediately sold the cost portion and retained only the profit portion of the shares was presumed to violate § 16(b)'s strictures prohibiting purchases and sales within a six month period. *Id. See* Keller Indus., Inc. v. Walden, 462 F.2d 388, 390 (5th Cir. 1972); Perlman v. Timberlake, 172 F. Supp. 246, 256 (S.D.N.Y. 1959). *Cf.* Park & Tilford, Inc. v. Schulte, 160 F.2d 984, 987 (2d Cir. 1947) (purchase given broad statutory definition).

[19] 421 F. Supp. at 1288; [1976-1977 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 95,754 at 90,714. The *Rosen* and *Freedman* courts both initially identified the SAR transactions as unorthodox transactions. This determination was founded on the fact that SARs involve options and also because plaintiffs' attempts to carve up an SAR transaction into a simultaneous purchase and sale did not fall within the literal phraseology of § 16(b). 421 F. Supp. at 1286; [1976-1977 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 95,754 at 90,710. *See* note 9 *supra.*

[20] *See* text accompanying note 12 *supra.* The *Rosen* court presumed that the insiders had access to inside information and thus satisfied the first part of the *Kern* test. This presumption of access to inside information is justified since the three officers granted SARs by the corporation had fiduciary responsibilities to remain knowledgeable and to participate in corporate decisions. *See, e.g.,* Kavanaugh v. Gould, 223 N.Y. 103, 106, 119 N.E. 237, 238 (1918). Nevertheless, the purpose of the SAR transaction of eliminating these officers arguably places these insiders in a hostile relationship with the corporate management thereby justifying further analysis of the officers' actual access to confidential information. *Cf.* Kern County Land Co. v. Occidential Petroleum Co., 411 U.S. 582, 596 (1973)(ten percent beneficial owner unwanted as a minority shareholder by management warranted inquiry into his actual access to inside information).

swing speculation.[21] The court also found lacking any element of control by the insiders since the timing of the SAR transaction was dictated by the corporation rather than the insiders possessing the options.[22] On the other hand, the *Freedman* court reasoned that SAR transactions did not involve the exercise of corporate stock options, but rather the surrender or lapse of such options.[23] Without a purchase,[24] prior and subsequent sales of stock were not in violation of section 16(b). Since no stock certificates attached to the surrender or lapse of the stock options, the court refused to analogize SAR transactions to a short swing exercise and sale of stock options.[25] The *Freedman* court declared that *Kern's* practical and balanced application of section 16(b) precluded any strained bifurcation of a single SAR transaction in order to fit the transaction within the proscriptive purview of the '34 Act.[26]

Although the *Rosen* and *Freedman* courts reached the same result, they utilized diverse analyses in applying the *Kern* rationale. The *Rosen* court narrowly interpreted *Kern* as permitting a liberalized inquiry into whether section 16(b) liability exists under the two pronged test of access and control.[27] However, while the *Kern* Court applied this test to determine if a purchase-sale transaction gave rise to speculative abuse, its liberalizing rationale would seem to allow an inquiry into whether a purchase or sale ever occurred. The *Freedman* court utilized *Kern* in such an expansive manner to justify a more fundamental inquiry into the overall applicability of section 16(b). The court inquired not only into the possibility of speculative abuse in the transaction,[28] but also into the more general question of

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[21] 421 F. Supp. at 1286-87.

[22] 421 F. Supp. at 1287. The board of directors controlled the dollar amount of the spread between the option price and the market price of the common stock because the market price was fixed as the market price on the day the board approved the SAR. *Id.* at 1284.

[23] [1976-1977 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 95,754 at 90,712-13. The *Freedman* court also presumed that the corporate executive had access to inside information. Since these insiders occupied a favored position in the corporation, this presumption appears well founded. *See* note 20 *supra.*

[24] *See* note 17 *supra.*

[25] [1976-1977 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 95,754 at 90,713. *See* text accompanying note 18 *supra.*

[26] [1976-1977 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 95,754 at 90,713-14.

[27] 421 F. Supp. at 1287-88. *See* Kern County Land Co. v. Occidential Petroleum Corp., 411 U.S. 582, 600 (1973); Gold v. Sloan, 486 F.2d 340, 344 (4th Cir. 1973), *cert. denied,* 419 U.S. 873 (1974); Ferraiolo v. Newman, 259 F.2d 342, 345 (6th Cir. 1958).

[28] The determination of whether there is a possibility for insider speculative abuse demands a difficult assessment of the mechanics of complex schemes used to shroud

whether the SAR transaction itself constituted a conventional, as opposed to technical, section 16(b) purchase or sale of securities.[29] The *Freedman* court found that the exercise of an SAR was not a sale of a stock option right to the corporation or an exercise of the option, but rather constituted a surrender or cancellation of the option in exchange for any profit which would have been realized had an option been exercised and purchased by the corporation.[30]

Importantly, section 16(b) liability is founded on a determination that a purchase and sale of equity securities took place and not merely upon a finding that the challenged transaction duplicated the result of a theoretical purchase and sale transaction. The *Freedman* inquiry properly recognized section 16(b) as a narrowly confined proscriptive remedy which applies only to actual short swing purchase and sale situations.[31] Through a comprehensive and realistic analysis of the mechanics of SAR transactions, the *Freedman* court avoided the difficult determination of insider trading abuse by refusing to bifurcate a single transaction into a hypothetical purchase and sale transaction. Thus, the *Freedman* decision correctly refocused post-*Kern* section 16(b) liability determinations on the critical issue of whether a purchase or sale of equity securities occurred.

Recently adopted changes to SEC Rules 16(b)-3 and 16(b)-6 support the results in both *Rosen* and *Freedman* and may effectively moot future litigation of SAR transactions under section 16(b).[32] These rules recognize SAR transactions as legitimate tools for executive compensation and exempt SARs from section 16(b) coverage.[33] In accommodation of the distinctions drawn by *Rosen* and *Freedman*, the rules demand disinterested administration of corporate SAR plans by persons ineligible for selection as recipients of SARs and describe SARs as expirations or surrenders of stock options to the

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insider trading abuses. *See, e.g.*, Foremost-McKesson, Inc. v. Provident Securities Co., 506 F.2d 601, 610-14 (9th Cir. 1974), *aff'd*, 423 U.S. 232 (1976).

[29] *Cf.* Gold v. Sloan, 486 F.2d 340 (4th Cir. 1973)(no automatic rule that an exchange is or is not a purchase or sale). *See* Wentz, *supra* note 4, at 240-43.

[30] [1976-1977 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 95,754 at 90,712-13.

[31] *Id.* at 90,713-14.

[32] 42 Fed. Reg. 754 (1977), *to be codified in* 17 C.F.R. §§ 240.16b-3, 240.16b-6.

[33] These newly adopted SEC rules are subject to federal judicial scrutiny. *See, e.g.*, Perlman v. Timberlake, 172 F. Supp. 246, 254 (S.D.N.Y. 1959). Judicial review of SEC rules is limited, in that the court "may not substitute its judgment for the more informed and expert judgment of the Commission." *Id.* The Commission must have abused its power or overstepped its statutory authority before a federal court may exercise its power to review and act. *Id. See generally* 3 K. DAVIS, ADMINISTRATIVE LAW TREATISE § 21.01 (1958).

corporate issuers.[34] These guidelines, together with the decisions in *Rosen* and *Freedman,* properly identify SARs as executive compensation programs which afford insiders little control over transactions and which do not involve traditional purchases and sales of securities.

In another recent decision, *Morales v. Mapco Inc.,*[35] the Tenth Circuit refused to make a similar section 16(b) exemption for stock transactions which involved an insider actually exercising stock warrants prior to their mandatory conversion into common stock. In *Morales,* Ross, the financial vice president of Mapco,[36] purchased 3,616 warrants[37] at $9.00 per warrant which were automatically convertible into one-half shares of Mapco common stock on April 1, 1972.[38] These warrants included the additional right to pay another $9.00 per warrant any time prior to the expiration date and thereby convert each warrant into one full share of Mapco.[39] Just prior to the mandatory conversion date, when the market price of Mapco had risen to more than $40.00 per share, Ross executed three transactions: first, between February 29th and March 23rd, he exchanged 1,100 warrants and paid $9,900.00 for 1,100 shares of Mapco stock; second, almost simultaneous with each of these exchanges, Ross sold the shares of common stock on the New York Stock Exchange; and finally, on March 24th, Ross exchanged his remaining 2,516 warrants and paid $22,644.00 for 2,516 Mapco common shares.[40] By paying the

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[34] 42 Fed. Reg. 759 (1977). The new rules themselves have been subject to a proposed amendment which clarified the control of the SAR transactions by disinterested corporate management. Under the original rules, the corporate board of directors or executive committee was not required to control the insider's right to exercise his SAR. The proposed amendment clarified Rule 16b(c)(3) to include a board or committee power to approve or disapprove any insider's exercise of his SAR. 42 Fed. Reg. 15,923 (1977).

[35] 541 F.2d 233 (10th Cir. 1976), *cert. denied,* 97 S. Ct. 768 (1977).

[36] The district court and the Tenth Circuit inferred from Ross' status as an officer of the corporation that he had access to inside information. Morales v. Mapco, Inc., 541 F.2d 233, 236-37 (10th Cir. 1976) *rev'g* [1974-1975 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 95,094 at 97,879 (N.D. Okl. Apr. 10, 1975). *See* note 20 *supra.*

[37] A corporate warrant constitutes a right to purchase shares of a corporation. Such warrants are customarily traded both on the stock exchanges and in the over-the-counter market. 1 L. LOSS, SECURITIES REGULATION 467 (2d ed. 1961).

[38] 541 F.2d at 234. Ross purchased all 3616 warrants between March, 1964 and June, 1971. Thus, if the warrant conversions were found merely to be an exchange of economic equivalents, sales after January, 1972 would all occur outside the § 16(b) statutory period. *See* Blau v. Ogsbury, 210 F.2d 426 (2d Cir. 1954); note 43 *infra.*

[39] 541 F.2d at 234.

[40] *Id.* 234-35. The price of a common share of Mapco varied during this period from $41.00 to $43.25. Assuming the higher of these prices, Ross received Mapco stock valued at $108,817.00 and $47,575.00 in cash from a total cash investment of $65,088.00

additional $9.00 per warrant, Ross, along with ninety-eight percent of all warrant holders effectively doubled the amount of profits realized in his purchase of Mapco warrants.[41]

In a stockholder's derivative suit brought in federal district court, the court held Ross' transactions did not constitute a section 16(b) violation.[42] The court reasoned that the insider warrant transactions did not constitute a purchase of stock but rather merely an exchange of economic equivalents.[43] Ownership of a Mapco warrant plus $9.00 was held to equal ownership of a full share of Mapco.[44] The district court also found that the almost simultaneous nature of the conversion and sale gave Ross no time span in which to misuse his insider position.[45] Finally, the court emphasized Ross' lack of control by finding that, to the extent Ross would have forfeited a substantial profit

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for the purchase of the warrants and the additional $9.00 necessary to effect the conversion. Thus, he realized a profit of $91,304.00 on his actual warrant transaction.

[41] Assuming the market price remained the same, had Ross waited until the automatic conversion date, he would have held 1,808 Mapco shares valued at $78,196.00 from an investment of $32,544.00 for the purchase of the warrants. This would have given him a profit of only $45,652.00, $45,652.00 less than the profit he realized by the exchange. *See* note 40 *supra*.

[42] [1974-1975 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 95,094 at 97,880.

[43] The concept of economic equivalents was first raised in Ferraiolo v. Newman, 259 F.2d 342 (6th Cir. 1958). In *Ferraiolo*, a director converted preferred shares to common shares and sold the common shares within six months of this conversion. 259 F.2d at 344. The court, declaring a policy of avoiding "black letter rubric," held that every transaction which could reasonably be defined as a purchase must be so defined if the transaction lends itself to § 16(b) speculative abuse. However, absent such opportunity for speculative abuse the definition of a purchase need not be expanded to encompass these transactions. *Id.* at 344-45. The court then analyzed the transaction of converting preferred shares for common shares to ascertain whether it qualified as a § 16(b) purchase. First, the court announced that preferred shares, due to their undilutable conversion privilege to common stock, constitutes the economic equivalent of common shares. Further, the court found that this conversion of economic equivalents did not give rise to speculative abuse since all preferred shareholders were treated alike, full disclosure was made to all shareholders, there was no material change in ownership, the transaction had none of the economic indicia of a purchase, and finally, since the corporation was going to redeem automatically all preferred shares at a price $9.00 less than the price of common stock, conversion was economically involuntary. *Id.* at 346. *See generally* Comment, *Conversion To Avert Redemption Is Not a "Short-Swing" Purchase,* 11 STAN. L. REV. 358 (1959).

[44] [1974-1975 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 95,094 at 97,878-79. Much like the preferred shares which sold for the same price as common shares in *Ferraiolo*, *see* note 43 *supra*, the *Morales* district court accepted testimony which indicated that Mapco warrants sold for the same price as Mapco common shares less the $9.00 conversion differential.

[45] *Id.* at 97,879. *See* text accompanying note 21 *supra*.

by not exchanging his warrants, the exchange was involuntary.[46]

The Tenth Circuit's reversal and finding of section 16(b) liability rejected each of the district court's bases for nonliability. The court of appeals acknowledged an exemption from section 16(b) liability when an insider converted true equivalents.[47] The court, however, held that Ross' transactions did not involve equivalents because there was a change in equity ownership since Mapco warrants were only a right to purchase whereas common stock gave an ownership interest in Mapco,[48] and because the conversion required the payment of an additional $9.00, making Mapco warrants economically unequal on their face to Mapco common shares.[49] The Tenth Circuit also rejected the position that the transactions were involuntary, since Ross exercised his warrants upon his "voluntary" payment of the additional $9.00. Finally, the court refused to adopt the district court's analysis

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[46] *See* notes 40-41 *supra*. The court's position on the economically involuntary nature of Ross' exchange is supported by the fact that ninety-eight percent of all Mapco warrant holders elected to exchange their warrants prior to the automatic conversion date. This same situation existed in *Ferraiolo*. *Compare* [1974-1975 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 95,094 at 97,879 *with* Ferraiolo v. Newman, 259 F.2d 342, 345 (6th Cir. 1958) (99% of preferred shareholders converted to common shares).

[47] The Tenth Circuit noted Ferraiolo v. Newman, 259 F.2d 342 (6th Cir. 1958) as an example of an exchange of true equivalents. 541 F.2d at 235. The *Morales* court, however, emphasized the *Ferraiolo* decision's requirements of a situation involving an exchange of equivalents situation which did not present an increase in the possibility of speculative abuse. Specifically, the court demanded that the exchange of equivalents not materially alter the proportions of equity ownership, be involuntary because of the possibility of monetary loss, and have none of the economic indicia of a purchase. *Id.* at 235 *citing* Ferraiolo v. Newman, 259 F.2d 342, 346 (6th Cir. 1958). *See* note 43 *supra*. Other courts have used the *Ferraiolo* criteria as the basis for determining whether a true exchange of equivalents has taken place. *Compare* Petteys v. Butler, 367 F.2d 528 (8th Cir. 1966), *cert. denied*, 385 U.S. 1006 (1967)(conversion of preferred to common stock dictated by corporate decision to redeem preferred stock at substantial discount from equivalent common stock not a § 16(b) purchase) *with* Bershad v. McDonough, 428 F.2d 693 (7th Cir. 1970), *cert. denied*, 400 U.S. 992 (1971)(agreement granting option which passed stock into escrow and gave grantee proxy to vote qualifies as § 16(b) sale) *and* Booth v. Varian Assoc., 334 F.2d 1 (1st Cir. 1964), *cert. denied*, 379 U.S. 961 (1965)(exchange of stock between two corporations where price fixed on closing day constituted a purchase within § 16(b)).

[48] 541 F.2d at 235-36. *See* note 47 *supra*.

[49] 541 F.2d at 235. Ross' paying cash to the corporation gave the exchange of Mapco warrants an economic indicia of a purchase. *See* note 47 *supra*. Like the *Freedman* court's refusal to bifurcate an SAR transaction into a purchase and sale, *see* text accompanying notes 29-30 *supra*, the *Morales* court did not theorize that Ross' warrant transactions duplicated the result of the automatic conversion of economic equivalents as to the one half shares of Mapco which Ross would have obtained.

that the simultaneous nature of the transactions removed any possibility for insider trading abuse.[50]

The court's reasoning on this final point is ambiguous. The district court's conclusion that there was no time span for abuse within each separate and simultaneous warrant exchange and resultant sale of stock seems reasonable since the rationale of the *Rosen* court in analyzing SARs would be applicable here.[51] There were, however, prior and subsequent warrant exercise-sale transactions conducted at varying intervals which could be matched with each simultaneous purchase and sale transaction. For example, the exercise of 2,516 warrants on March 24th could be matched with the sale of 200 shares in the simultaneous transaction on February 28th. Thus, although the simultaneous nature of the initial transactions might have removed any possibility for speculative abuse between that exercise and sale, it did not remove such possibility between those purchases and sales and the prior and subsequent purchases and sales within the six month period of section 16(b). Because the Tenth Circuit did not adequately present this reasoning, the *Morales* opinion can be criticized; but because there was more than one simultaneous transaction within six months, the court's conclusion was correct.

The *Morales* decision also represents a harsh position toward corporate insider trading despite the liberalizing analysis of *Kern*. To prove an exchange of equivalents, the *Morales* court demanded an exchange of identical ownership interests as well as economic value equivalents.[52] The distinction between owning a share of the company and owning the right to purchase a share, however, appears to be an attenuated interpretation of the concept of ownership equivalence.[53] The court's conclusion, however, is supportable since the introduction of cash into the exchange destroyed any true economic equivalence.

The position of the *Morales* court on the voluntariness of these transactions clearly demonstrates the court's strict application of sec-

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[50] 541 F.2d at 236.

[51] Section 16(b) eliminated short swing insider transactions. When purchases and sales are immediate, there is no time span in which an insider can benefit from confidential information. *See* text accompanying note 21 *supra*.

[52] The language in the *Ferraiolo* opinion supports the Tenth Circuit's position that there must be some equivalence in ownership interests in order for a transaction to be characterized as an exchange of equivalents. *See* note 47 *supra*.

[53] Any distinction between warrants and stocks is especially tenuous in view of the inclusion of both within the '34 Act's broad definition of equity securities. *See* note 3 *supra*.

tion 16(b). The court identified these transactions as voluntary merely because Ross voluntarily initiated the exchange when he paid the additional $9.00 for conversion. That payment, however, was dictated by the terms levied by the corporation in its warrant contract.[54] The court constructed a voluntariness test which focused on the mechanics of the conversion rather than on the economic forces, such as the loss of money if the securities were left unconverted, which has played the critical role in determinations of involuntariness by other courts.[55] Under this test, few situations can possibly arise where the warrant, option, or preferred stockholder does not take some voluntary action in initiating the conversion process.[56]

Although the *Morales* court may have erroneously held that Ross' exercise of warrants was voluntary, an opposite holding of involuntariness does not automatically mean that the warrant exercise was not a section 16(b) purchase. In *Kern,* the Supreme Court declared that involuntariness exempted purchases or sales from coverage under the '34 Act only when coupled with an absence of speculative abuse.[57] Since the series of purchases and sales in *Morales* gave rise to a possibility that Ross could misuse his inside information,[58] these warrant exercises remained within the reach of section 16(b).

Morales reached an appropriate result despite an overly strict interpretation of the voluntariness element of the *Kern* test. While this departure from a traditional measurement of voluntariness was not critical in the *Morales* situation since there was a possibility for insider abuse, future litigation where there is no such possibility could be incorrectly decided if courts elect to adopt the *Morales* court definition of voluntariness.[58] Such a result, however, seems unlikely

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[54] 541 F.2d at 234.

[55] *See* Kern County Land Co. v. Occidential Petroleum Corp., 411 U.S. 582, 600 (1973); American Standard, Inc. v. Crane Co., 510 F.2d 1043, 1048-49 (2d Cir. 1974), *cert. denied,* 421 U.S. 100 (1975); Petteys v. Butler, 367 F.2d 528, 534 (8th Cir. 1966); Ferraiolo v. Newman, 259 F.2d 342, 346 (6th Cir. 1958). *See generally* Note, *Involuntariness and Other Contemporary Problems Under Section 16(b) of the Securities Exchange Act of 1934,* 27 HASTINGS L.J. 679 (1976).

[56] *See, e.g.,* Ferraiolo v. Newman, 259 F.2d 342, 344 (6th Cir. 1958). In *Ferraiolo,* the corporate insider voluntarily surrendered his preferred stock to the corporation to initiate the conversion of these preferred shares into common shares. Under the *Morales* test, such an initiation would have removed this conversion from consideration as involuntary.

[57] 411 U.S. at 600. The *Kern* Court held: "the involuntary nature of the possibility of speculative abuse of inside information, convinces us that § 16(b) should not apply . . . ." *Id.*

[58] *See* text accompanying note 51 *supra.*

given the weight of contrary authority, buttressed by the *Kern* decision.[59]

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[59] *See* note 55 *supra*.