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CORPORATIONS—THE EXERCISE OF WARRANTS CONSTITUTES A PURCHASE UNDER SECTION 16(b)

Morales v. Mapco, Inc.[1]

In 1964 Mapco, Inc. issued warrants each of which was to be converted automatically into one-half share of Mapco common stock on April 1, 1972. Alternatively, one warrant plus $9.00 could be exchanged for one full share of Mapco stock prior to the expiration date.[2] The warrants had an anti-dilution clause which protected the warrant holders against the issuance of Mapco common stock at a consideration of less than $18.00 per share.

Ross, the financial vice-president of Mapco, acquired 3,616 warrants and held them for more than six months. Ross exercised his early conversion right, receiving 900 shares of common stock for 900 warrants,[3] and sold the stock through the New York Stock Exchange. All necessary forms regarding the transactions were filed with the Securities Exchange Commission.[4] A shareholder's derivative action was brought against Ross under section 16(b) of the Securities Exchange Act of 1934[5] to

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1. [1976-1977 Transfer Binder] FED. SEC. L. REP. (CCH) ¶95,704, at 90,451 (10th Cir. 1976).

2. Mapco was listed on the New York Stock Exchange; warrants were bought and sold in the over-the-counter market. On February 28, the date of the first transaction in question, Mapco common closed at $41.00, and on March 24 at $43.25. The stock reached a high of $52.25 on June 20, 1972.

3. Through his broker, Ross disposed of 200 warrants on February 28, 1972; 100 warrants on February 29, 1972; 200 warrants on March 6, 1972; and 400 warrants on March 9, 1972. Additionally, in March Ross sold 200 warrants to a third person and by the payment of $9.00 per warrant, secured 2,516 shares of Mapco common stock himself.

4. Ross filed a Form 4, "Statement of Changes in Beneficial Ownership of Securities," for the months of February and March, 1972. These forms listed the security as: "Warrants: Exercised and Sold as Common," gave the transaction date, and stated the "Amount Sold or otherwise disposed of" as a total of 1,100.

5. 15 U.S.C. § 78p(b) (1970) provides in part:

> 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 recoverable by the issuer, irrespective of any intention on the part of such beneficial owner, director, or officer in entering into such transaction . . . . 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 . . . .

recover any profits made by Ross on the sale of shares. The district court granted summary judgment for the defendant Ross, but the Tenth Circuit reversed holding that a cause of action had been stated against Ross under section 16(b).

Prior to the passage of the Securities Exchange Act of 1934, the common law provided few remedies[6] for the abuses[7] arising from insider trading. The majority of courts held that officers, directors, and substantial shareholders owed no fiduciary duty to corporate shareholders. Even if a fiduciary duty did exist, insider liability was difficult to establish. The common law remedies proved totally inadequate to deter abusive insider trading.

To alleviate these inadequacies, Congress passed section 16(b) of the 1934 Act to prevent "the unfair use of information" by an insider obtained "by reason of his relationship to the issuer."[8] The section provides that an insider who realizes a profit on the sale and purchase, or the purchase and sale, of the corporation's securities within a six month period can be forced to surrender those profits through an action brought by the corporation on its own behalf or by a shareholder in a derivative suit.[9] In this manner, Congress sought to curb the evils of insider trading by restricting the profits realized by insiders in transactions in which the possibility of abuse was believed to be intolerably great.

In applying section 16(b) the courts have fluctuated between two tests for insider liability: an objective test, and a pragmatic, subjective test. Under the objective approach, the only question is whether the transaction and the individual involved come within the literal statutory requirements of section 16(b).[10] Liability attaches as soon as it is shown

6. Remedies were limited under three theories of relief. Under the majority view, officers and directors owed no fiduciary duty to shareholders, and insiders were liable only if they perpetrated a fraud. *See, e.g.,* Board of Comm'rs v. Reynolds, 44 Ind. 509 (1873); Voellmeck v. Harding, 166 Wash. 93, 6 P.2d 373 (1931). A minority of jurisdictions held the corporate insider to a strict fiduciary duty of disclosure to shareholders in connection with the sale of shares. *See, e.g.,* Steinfield v. Nielsen, 15 Ariz. 424, 139 P. 879 (1914); Oliver v. Oliver, 118 Ga. 362, 45 S.E. 232 (1903). Several jurisdictions followed the "special facts" doctrine which stated that officers and directors did not owe a fiduciary duty to shareholders unless special facts made it inequitable for the insider to take advantage of the shareholders. *See, e.g.,* Strong v. Repide, 213 U.S. 419 (1909). *See generally* Comment, *Section 16(b): Insider Trading,* 1974 WASH. U.L.Q. 872.

7. For a list of abuses reported to Congress, see H.R. REP. Nos. 1383, 1838, 73d Cong., 2d Sess. (1934); S. REP. Nos. 792, 1455, 73d Cong., 2d Sess. (1934).

8. 15 U.S.C. § 78p(b) (1970).

9. *Id. See also* Kern County Land Co. v. Occidental Petroleum Corp., 411 U.S. 582, 595 (1972).

10. *See generally* Lowenfels, *Section 16(b): A New Trend in Regulating Insider Trading,* 54 CORNELL L. REV. 45 (1968); 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).

that a statutory insider has purchased and sold the securities in question for a profit within a six month period. Whether the insider actually used inside information or whether the transaction possibly could lend itself to the type of speculative abuse that the statute was designed to prevent are irrelevant questions.

The majority of section 16(b) decisions between 1934 and 1964 regarded the objective approach as vital to the protection of the investing public against insider abuses. In *Smolowe v. Delendo Corp.*[11] the Second Circuit rejected the contention that the statute's preamble required the court to find actual use of inside information before liability attached. Noting that virtually any transaction within the definitional limits of section 16(b) will result in liability, the court stated that "[t]he statute is broadly remedial .... We must suppose that the statute was intended to .... establish a standard so high as to prevent any conflict between the selfish interest of a fiduciary officer ... and the faithful performance of his duty."[12] Similarly, in *Park & Tilford, Inc. v. Schulte*[13] the Second Circuit specifically adopted the objective approach and concluded that once the statutory requirements of 16(b) are met, liability will attach whether or not the transaction was of the type Congress specifically intended to proscribe.

Dissatisfied with the harsh result often produced by the literal interpretation of section 16(b), courts increasingly have adopted a pragmatic approach. This subjective analysis is a two-step process. As in the objective approach, the court first will determine whether the transaction and the individual involved come within a broad reading of the statute. If so, the court will examine the particular circumstances to determine whether that situation possibly could have given rise to an abuse of inside information. Liability will ensue if the possibility of abuse existed.[14]

The pragmatic approach in section 16(b) analysis did not actually emerge until 1965 in *Blau v. Max Factor & Co.*[15] The Ninth Circuit looked beyond the literal requirements of the statute to inquire whether the transaction under scrutiny offered the insider the *opportunity* to use inside information in short-term speculation.[16] In that case, insiders converted common stock into "class A" stock which they subsequently sold on the market. The court refused to hold that such an exchange was a purchase within the meaning of section 16(b) because "the making of the exchange ... [was] simply irrelevant to the use of insider information in

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11. 136 F.2d 231, 236 (2d Cir.), *cert. denied,* 320 U.S. 751 (1943) (directors and officers who had purchased and sold corporate common stock within a six month period were held liable for short-swing profits).
12. *Id.* at 239.
13. 160 F.2d 984 (2d Cir.), *cert. denied,* 332 U.S. 761 (1947).
14. Lowenfels, *supra* note 10; Wentz, *supra* note 10.
15. 342 F.2d 304 (9th Cir.), *cert. denied,* 382 U.S. 892 (1965).
16. *Id.* at 308.

short-term speculation—the problem with which Section 16(b) is concerned."[17]

Since *Max Factor*, courts have been more willing to look at the facts surrounding each transaction to determine whether it is the type which might lend itself to the abuse of inside information.[18] The Second Circuit has changed its approach since *Park & Tilford* and has begun examining each case on an ad hoc basis to determine whether the transaction comes within the purpose of the Act.[19] In 1966 the Eighth Circuit in *Petteys v. Butler*[20] specifically refused to follow the objective rule prescribed in *Park & Tilford*. Application of the pragmatic approach is a growing trend, especially where "unorthodox transactions" are involved.[21]

Under both the objective and pragmatic approaches, it first must be determined whether the transaction is within the general definitional boundaries of section 16(b).[22] The transactions in *Mapco* were clearly within the statutory definition. The defendant Ross was an "officer"[23] of Mapco who realized profits from what was arguably the "purchase and sale"[24] of an equity security[25] within a six month period.[26] It is irrelevant whether Ross actually used inside information while carrying out his transactions[27] because by definition liability ensues "irrespective of any intention . . . ."[28]

17. *Id.* at 309.

18. Kern County Land Co. v. Occidental Petroleum Corp., 411 U.S. 582 (1973); Petteys v. Butler, 367 F.2d 528 (8th Cir. 1966), *cert. denied*, 385 U.S. 1006 (1967); Blau v. Lamb, 363 F.2d 507 (2d Cir. 1966), *cert. denied*, 385 U.S. 1002 (1967); Ferraiolo v. Newman, 259 F.2d 342 (6th Cir. 1958), *cert. denied*, 359 U.S. 927 (1959).

19. Blau v. Lamb, 363 F.2d 507 (2d Cir. 1966), *cert. denied*, 385 U.S. 1002 (1967).

20. 367 F.2d 528, 533 (8th Cir. 1966), *cert. denied*, 385 U.S. 1006 (1967).

21. Unorthodox transactions involve dealings other than the normal cash-for-stock exchange. Examples include dealings in options, warrants and rights, merger situations, and stock conversions. *See* text accompanying notes 29, 34-50 *infra*.

22. *See* note 5 *supra*.

23. An "officer" is a "president, vice-president, . . . and any other person who performs for an issuer . . . functions corresponding to those performed by the foregoing officers." 17 C.F.R. § 240.3b-2 (1977). *See also* Colby v. Klune, 178 F. 2d 872, 873 (2d Cir. 1949) (another definition of "officer").

24. *See* notes 29-37 and accompanying text *infra*.

25. *See* 15 U.S.C. § 78c(a)(11) (1970). Except for the limitations that the equity security must be "non-exempt" and be registered pursuant to § 12 of the 1934 Act, the term equity security has been defined broadly to include stock, similar securities whether or not issued by a corporation, securities convertible into stock or similar securities, and warrants and rights.

26. [1976-1977 Transfer Binder] FED. SEC. L. REP. (CCH) at 90, 453-54.

27. Since the pragmatic approach is concerned with the *possibility* of abuse rather than actual abuse, the intention of the insider also is irrelevant under the pragmatic test.

28. 15 U.S.C. § 78p(b) (1970).

The problem in *Mapco* was whether the conversion of warrants into Mapco stock was a "purchase" within section 16(b). Although traditional cash-for-stock transactions clearly are encompassed by section 16(b), the question of the inclusion or exclusion of certain "unorthodox" transactions such as options, rights, and warrants has not been so clear.[29]

From the objective test viewpoint, there would be no doubt that a "purchase and sale" of Mapco common stock took place. Courts generally have agreed that the exercise of warrants into common stock is a "purchase" within the statute[30] based on a broad definition of "purchase" which includes "any contract to buy, purchase, or otherwise acquire."[31] For example, the court in *Park & Tilford* held that the exercise of an option to convert preferred stock into common stock, followed by a sale of the common stock within six months, was a "purchase and sale" within the meaning 16(b).[32] In *Mapco* Ross did not own stock by holding the warrants. However, upon the payment of $9.00 the warrant could be converted into one share of stock. This was a purchase within the meaning of the statute. The transaction thus was within the literal boundaries of section 16(b) as required by both the objective test and the first step of the pragmatic analysis. The pragmatic test requires the further finding that there was a "possibility of speculative abuse."[33] An analysis of the facts will support the court's finding that Ross' transactions were purchases subject to speculative abuse.

In determining whether a particular unorthodox transaction lends itself to speculative abuse, courts have taken into consideration such factors as the voluntary nature of the conversion,[34] the economic indicia of the purchase,[35] whether the transaction involves economic equivalents,[36] and the insider's position in the company and his awareness of current market trends.[37]

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29. For a discussion on unorthodox transactions, see Wentz, *supra* note 10; Comment, *supra* note 6, at 884.

30. Shaw v. Dreyfus, 172 F.2d 140, 142 (2d Cir.), *cert. denied*, 337 U.S. 907 (1949); Blau v. Hodgkinson, 100 F. Supp. 361, 374 (S.D.N.Y. 1951).

31. Park & Tilford, Inc. v. Schulte, 160 F.2d 984, 987 (2d Cir.), *cert. denied*, 332 U.S. 761 (1947); 15 U.S.C. § 78c(a)(13) (1970).

32. 160 F.2d at 987.

33. Kern County Land Co. v. Occidental Petroleum Corp., 411 U.S. 582, 595 (1973); Reliance Elec. Co. v. Emerson Elec. Co., 404 U.S. 418, 424 n.4 (1972); Blau v. Lamb, 363 F.2d 507, 521-23 (2d Cir. 1966), *cert. denied*, 385 U.S. 1002 (1967); Ferraiolo v. Newman, 259 F.2d 342, 345 (6th Cir. 1958), *cert. denied*, 359 U.S. 927 (1959).

34. Ferraiolo v. Newman, 259 F.2d 342 (6th Cir. 1958), *cert. denied*, 359 U.S. 927 (1959).

35. *Id.*

36. *Id.*; Blau v. Lamb, 363 F.2d 507 (2d Cir. 1966), *cert. denied*, 385 U.S. 1002 (1967).

37. Kern County Land Co. v. Occidental Petroleum Corp., 411 U.S. 582 (1973).

An example of an unorthodox transaction in which courts have utilized these factors to determine the possibility of speculative abuse is the exchange of shares following a merger.[38] Two factors appear crucial in this situation: the insider's ability to control the merger and, if he has no control of the merger, whether he has access to inside information concerning the merger.[39] If an insider is able to control the merger and dictate its terms, courts have found potential for speculative abuse and the insider will be liable for any short-swing profits made.[40] If the insider has no control over the merger, the court should look to the question of access to information;[41] access may indicate the possibility of abuse. Thus, in determining whether an exchange of shares upon merger constitutes a sale, a court first looks to control and, if none is found, then examines the question of access to inside information.

In *Ferraiolo v. Newman*,[42] carefully considered by the court in *Mapco*, it was held that the conversion of preferred stock into common stock did not lend itself to the practices which section 16(b) was enacted to prevent. The court considered the preferred and common stocks as economic equivalents because there was no material change in proportional equity ownership after the transaction.[43] The court pointed out that no money had been paid for the conversion of preferred into common stock. The court further noted that the transaction was involuntary for all practical purposes because it had been forced genuinely and intentionally by a call for redemption.[44] These factors led the court to conclude that the transaction was not subject to speculative abuse and had none of the "economic indicia of a purchase."[45] As a result, liability did not attach. It therefore appears that the conversion of one class of stock for another may not be within the scope of activity that section 16(b) was designed to prevent.

38. Wentz, *supra* note 10, at 235.

39. Kern County Land Co. v. Occidental Petroleum Corp., 411 U.S. 582 (1973); Newmark v. RKO Gen., Inc., 425 F.2d 348 (2d Cir.), *cert. denied*, 400 U.S. 854 (1970).

40. Newmark v. RKO Gen., Inc., 425 F.2d 348 (2d Cir.), *cert. denied*, 400 U.S. 854 (1970).

41. *See* Kern County Land Co. v. Occidental Petroleum Corp., 411 U.S. 582 (1973) where the court held that there was no possibility of abuse in an unsuccessful tender offeror's exchange of stock following a defensive merger. If the insider had access to inside information concerning the merger when he made the purchase to be matched with the exchange of shares (sale) upon merger, then a possibility of abuse exists. Clearly the insider, knowing that merger would take place and that the new shares would be worth more than the old, could abuse his position by purchasing before the merger at lower prices in theexpectation that he would receive something more valuable upon merger. The insider's access to inside information concerning the merger has clearly given him a choice which can be turned to speculative abuse.

42. 259 F.2d 342, 346 (6th Cir. 1958), *cert. denied*, 359 U.S. 927 (1959).

43. *Id.* at 345-46.

44. *Id.*

45. *Id.*

Mapco involved a different "unorthodox transaction" from those already mentioned. This transaction was the conversion of warrants into common stock and the subsequent sale thereof. The district court, citing *Ferraiolo,* held that the warrants were the economic equivalents of common stock and that therefore the conversion did not constitute a "purchase" for the purposes of section 16(b).[46] The court's finding was due in part to the fact that the warrants were automatically convertible[47] and contained an anti-dilution clause.[48]

The Tenth Circuit[49] reversed, concluding that the warrants and the Mapco common stock were not economic equivalents. *Ferraiolo* was distinguished on the ground that the preferred stockholder had an equity ownership and his subsequent conversion of preferred into common stock left his equitable interest basically unchanged. As a result, the preferred and common stocks were held to be economic equivalents.[50] A warrant, on the other hand, does not represent a present equity interest in a corporation; it represents nothing more than a right to acquire such an interest at a future time.[51] Thus, the Mapco warrant-holder had no equity ownership until the warrant was exercised or terminated. The court held that because Ross had no equity ownership before the exercise of the warrants and did have equity ownership after the exercise, the transaction was a purchase within the scope of section 16(b).[52]

In holding that the transaction was outside the province of section 16(b), the district court noted that the simultaneous nature of the exercise of the warrants and the sale of the common stock gave no opportunity for abuse by Ross.[53] This argument is weak because Ross had been an insider prior to the exercise of the warrants and consequently was in a position to gain access to information which, when publicly released, conceivably could cause a decline in the market price of the stock.[54] In such a case, assuming that the exercise of the warrants was classified as a purchase rather than as a conversion, the immediate sale of the common stock could be predicated upon the type of speculative abuse at which the statute is directed. Ross' position in the company and his awareness

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46. [1974-1975 Transfer Binder] FED. SEC. L. REP. (CCH) ¶95,094, at 97,875 (N.D. Okla. 1975).

47. *Id.* The court found that since the warrants were automatically convertible upon expiration, there was an absence of voluntariness.

48. *Id.*

49. [1975-1976 Transfer Binder] FED. SEC. L. REP. (CCH) ¶95,704, at 90,451 (10th Cir. 1976).

50. Ferraiolo v. Newman, 259 F.2d 342, 345 (6th Cir. 1958), *cert. denied,* 359 U.S. 927 (1959).

51. Hazen, *The New Pragmatism Under Section 16(b) of the Securities Exchange Act,* 54 N.C.L. REV. 1, 9 (1975).

52. Morales v. Mapco, Inc., [1975-1976 Transfer Binder] FED. SEC. L. REP. (CCH) ¶95,704, at 90,454 (10th Cir. 1976).

53. *Id.* at 97,879.

54. Hazen, *supra* note 51, at 27.

of the current market rendered him liable for any short-swing profits because the resulting transactions included the possibility of speculative abuse. There need not be actual speculative abuse for liability to attach; the *possibility* of such abuse is sufficient.

Ross should be liable for the short-swing profits realized under either the objective or pragmatic approach. Applying the objective approach, Ross was an insider and the "purchase and sales" took place within the statutory period. Under the pragmatic approach, the exercise of the warrants constituted a purchase within section 16(b) and the transaction contained the possibility of speculative abuse of inside information.

For unorthodox transactions such as that in *Mapco*, the pragmatic test is the better approach to determine insider liability under section 16(b). To hold an insider liable under the literal objective approach would hinder the use of business incentive plans such as stock options, warrants, and convertible securities. The knowledge that the ability to dispose of stock acquired through one of the above plans might be limited could make insiders reluctant to accept the arrangement. Although the pragmatic approach does provide more protection for the insider by requiring the *possibility* of abuse in the transaction, it too may hinder the use of these "bonus" plans for officers and employees. Because a finding of actual abuse is not required, a perfectly innocent insider may have to account to the corporation for any profits realized from an unorthodox transaction. In the *Mapco* situation, the pragmatic approach might impose liability even if he had let the warrants automatically convert into Mapco common stock.[55] This result may seem unfair if inside information was not actually used, but such a finding is necessary in order to protect the interests of outside investors. Corporate insiders owe primary loyalty to the corporation and should not enter transactions which may have a detrimental effect on shareholder interests.[56] The pragmatic approach has the effect of protecting these interests. It may be argued that the test should be whether actual abuse has occurred. Such abuse, however, is difficult to prove. Because insiders possess special knowledge that outside shareholders lack, it would be an unfair advantage to let them deal freely in the company's securities when such knowledge may benefit them at the expense of other shareholders. The outside shareholder interest should be the primary concern of the corporation and therefore insider trading must be restricted in those situations where the possibility of speculative abuse exists.

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55. In such a case, even though Ross' special knowledge would not benefit him in the conversion of the warrants, it possibly could benefit him when he subsequently sold the stock.

56. The sale of a large number of shares by insiders could cause a drop in the stock's market price thereby causing shareholder interests to decline.