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Securities: Liability of a Partner-Director for Short-Swing Profits

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law" means the whole law which encompasses conflict of law rules. Whenever the word law means something less than the whole law it does so only because it has been expressly delimited. Since Congress did not delimit the word law under the Tort Claims Act, the states' conflict of laws rules continue to operate under the Act.

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Securities: Liability of a Partner-Director for Short-Swing Profits—A partner of Lehman Bros., an investment firm having over one hundred partners, succeeded a fellow partner as a member of the board of directors of Tidewater Associated Oil Company, a corporation the stock of which was traded on a national exchange. During his tenure as a director of Tidewater, the investment firm of which he was a partner bought and sold 50,000 shares of stock in this corporation within a 6 month period at a profit of $98,686.77.

Plaintiff, a stockholder of Tidewater, sues on behalf of the company under section 16(b)[1] of the Securities Exchange Act of 1934 to recover with interest all the short swing profits[2] which the partnership derived while the co-defendant partner served as a director of Tidewater. On cross-appeals from a judgment dismissing the complaint against the partnership and allowing recovery against the partner-director for his proportionate share of the profits only, the decision was affirmed by the Court of Appeals and by the United States Supreme Court.[3]

The Securities Exchange Act was passed amidst widespread revelations of the use of undisclosed information by insiders who traded securities listed on national exchanges. Prior to passage of the Act speculation by insiders in the securities of their corporations was a widely

[1] "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 and not comprehended within the purpose of this subsection." 15 U.S.C. §78p(b) (1952).

[2] ". . . that is profits earned within a six months' period by the purchase and sale of securities, . . ." Blau v. Lehman, 368 U.S. 403 (1962).

[3] Blau v. Lehman, 268 F. 2d 786 (1960); 368 U.S. 403 (1962).

condemned evil.[4] Yet, generally, prior to the passage of this Act, aggrieved stockholders had no right to recover for the corporation any inside profits derived by an officer, director, or other insider.[5] Under special circumstances an insider might have been held liable as under the rule of *Strong v. Repide.*[6] However, even this remedy was inadequate because of the heavy burden of proof imposed upon the stockholders.[7] The introduction to the act specifically enumerates the reasons which compelled Congress to act, ranging from the effect on the public welfare during national emergencies to the effect of excessive speculation on the expansion and contraction of credit.[8]

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[4] Smolowe v. Dolendo Corporation, 136 F. 2d 231, 235 (1943).

[5] Blabon v. Hay, 269 Miss. 401, 169 N.E. 268 (1929); Walsh v. Goulden, 130 Mich. 531, 90 N.W. 406 (1902); Seitz v. Frey, 152 Minn. 170, 188 N.W. 266 (1922).

[6] "It is not here sought to make defendant responsible for his actions, not alone and simply in his character as a director, but because, in consideration of all the existing circumstances above detailed, it became the duty of the defendant, acting in good faith, to state the facts before making the purchase. . . . The case before us seems a plain one for holding that, under the circumstances detailed, there was a legal obligation on the part of the defendant to make the disclosure." Strong v. Repide, 213 U.S. 419, 432-434 (1909).

[7] Liability would apply to the facts only and, even then it could be overridden by a primary duty of the director to the corporation to keep information secret. Oliver v. Oliver, 118 Ga. 362, 45 S.E. 232 (1903).

[8] "For the reasons hereinafter enumerated, transactions in securities as commonly conducted upon securities exchanges and over-the-counter markets are affected with a national public interest which makes it necessary to provide for regulation and control of such transactions by officers, directors, and principal security holders, to require appropriate reports, and to impose requirements necessary to make such regulation and control reasonably complete and effective in order to protect interstate commerce, the national credit, the Federal taxing power, to protect and make more effective the national banking system and Federal Reserve System, and to insure the maintenance of fair and honest markets in such transactions:

(1) Such transactions (a) are carried on in large volume by the public generally and in large part originate outside the States in which the exchanges and over-the-counter markets are located and/or are effected by means of the mails and instrumentalities of interstate commerce; (b) constitute an important part of the current interstate commerce; (c) involve in large part the securities of issuers engaged in interstate commerce; (d) involve the use of credit, interstate commerce, and directly affect and influence the volume of interstate commerce; and affect the national credit.

(2) The prices established and offered in such transactions are generally disseminated and quoted throughout the United States and foreign countries and constitute a basis for determining and establishing the prices at which securities are bought and sold, the amount of certain taxes owing to the United States and to the several States by owners, buyers, and sellers of securities, and the value of collateral for bank loans.

(3) Frequently the prices of securities on such exchanges and markets are susceptible to manipulation and control, and the dissemination of such prices gives rise to excessive speculation, resulting in sudden and unreasonable expansion and unreasonable contraction of the volume of credit available for trade, transportation, and industry in interstate commerce, (b) hinder the proper appraisal of the value of securities and thus prevent a fair calculation of taxes owing to the United States and to the several States by owners, buyers, and sellers of securities, and (c) prevent the fair valuation of collateral for bank loans and/or obstruct the effective operation of the national banking system and Federal Reserve System.

(4) National emergencies, which produce widespread unemployment and the dislocation of trade, transportation, and industry, and which burden inter-

Section 16(a)[9] requires officers, directors, and beneficial owners of more than ten per cent of the stock of the issuing corporation to disclose their equity interests to the Securities and Exchange Commission. Further, such parties under 16(b) are liable for any short swing profits.[10] Designed to protect stockholders and the buying public, section 16 requires both full disclosure and absolute liability for any short swing profits.

Specifically, Section 16(b) is designed to prevent this reaping of short swing profits by one enjoying an inside position. In order to render a director, officer, or principal stockholder liable for his profits made on short swing speculation it is not necessary that proof be made of an actual unfair use of inside information by such individual. The Supreme Court has construed the Act to intend an objective rather than a subjective measure of proof.[11] It has been said that a federal court, in applying 16(b), must suppose that Congress intended the statute to be thoroughgoing and to squeeze all possible profits out of stock transactions, and thus to establish a standard so high as to prevent any conflict between the selfish interests of a fiduciary officer, director, or stockholder and the faithful performance of his duty.[12] Significant therefore is the feature that an insider is liable once it is shown that he has realized a short-term profit, whether or not an actual use of advance information is shown.

Plaintiff relied on three basic contentions in this appeal. First, contending that Lehman Brothers had deputized the partner, he insisted that it was in fact a director within the contemplation of 16(b). Secondly, he insisted that should the court find no deputization they should nevertheless hold the partnership liable because a partnership is an inseparable entity and since one member was obviously an insider the whole partnership should also be considered an insider. Finally, it was contended, under any conditions the partnership should be held liable on a policy basis so as to prevent the unfair use of information by such

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state commerce and adversely affect the general welfare, are precipitated, intensified and prolonged by manipulation and sudden and unreasonable fluctuations of security prices and by excessive speculation on such exchanges and markets, and to meet such emergencies the Federal Government is put to such great expense as to burden the national credit. 15 U.S.C. §78b.

9 "Every person who is directly or indirectly the beneficial owner of more than 10 per centum of any class of any equity security (other than an exempted security), which is registered on a national securities exchange, or who is a director or an officer of the issuer of such security, shall file, at the time of registration of such security or within ten days after he becomes such beneficial owner, director, or officer, a statement with the exchange (and a duplicate original thereof with the Commission) indicating his ownership at the close of the calendar month and such changes in his ownership as have occurred during such calendar month." 15 U.S.C. 78p(a).

10 Sec. 16(b) *supra* note 1.

11 *Smolowe v. Dolendo, supra* note 4.

12 *Ibid.;* Park and Tilford v. Schulte, 160 F. 2d 984 (1947); Kogenn v. Schulte, 61 F. Supp. 604 (1945).

large investment firms which, as a matter of practice, always seem to have their partners serving as directors for other companies. Failure to do so, plaintiff argued, will leave a large and unintended loophole in the statute—one substantially eliminating the great Wall Street trading firms from the statute's operation thereby defeating the very purpose of the Securities Exchange Act.[13]

The Supreme Court conceded that for the purposes of 16(b) the defendant partnership could be, under the proper circumstances, a director within the contemplation of 16(b) and thus liable for any short swing profits accruing. Such circumstances might exist if the facts showed the partnership to be actually functioning through a deputy in the form of the partner-director. But the court refused to upset the lower court's finding of fact that the partner had not been deputized. Nor did they accept the plaintiff's interpretation of §3(a)(9)[14] as treating a partnership as an inseparable entity. Rather, the court felt that the purpose of §3(a)(9) was merely to make it clear that a partnership can be treated as an entity under the statute, not that it must be. In answer to the plaintiff's final contention they rejected any idea that would hold such a partnership liable solely on a policy basis. In so holding they relied on the fact that Congress had rejected an original draft of the Securities Exchange Act which would have made all profits received by anyone, insider or not, to whom some unlawful disclosure had been made recoverable by the company. Significant also in the court's mind was the fact that Congress had done nothing to the Act during the eight year period since the Second Circuit Court of Appeals refused, in the *Rattner* case,[15] to apply §16(b) to Lehman Brothers in circumstances substantially similar to those in the present case.

If the trial court had found the partnership a director within the contemplation of the Act they would have been liable to the corporation for such profits regardless of whether they had in fact acted on confidential information known to them or available to them. Liability is imposed merely if one is an officer or sits on the board of directors and concurrently profits on a short swing basis while dealing in the corporation's stock. However, the court emphasized that the act itself "does not purport to impose its extraordinary liability on any person or fiduciary unless he or it is a director, officer, or beneficial owner of more than 10 per cent of any class of equity security."[16] This followed the previous pattern as set down by the majority opinion of the circuit court and which in turn was solidly based on the decision in *Rattner v. Lehman.*

[13] Blau v. Lehman, 286 F. 2d 786, 799 (1960).
[14] "The term 'person' means an individual, a corporation, a partnership, an association, a joint-stock company, a business trust, or an unincorporated organization." Securities Exchange Act of 1934, §3, 48 Stat. 883 (1934), 15 U.S.C. §78c (9) (1952).
[15] Blau v. Lehman, 368 U.S. 403, 82 S. Ct. 451, 456 (1961).
[16] Rattner v. Lehman, 193 F. 2d 564 (1952).

In the Rattner decision the court held the individual director liable for his proportionate share only, saying that the partnership, not being a director, was therefore not subject to the penalties of 16(b). Further, the court held that loophole or not, "legislative history indicates that omission of any provision for such liability was intentional."[17] Important in our consideration is that Justice Learned Hand rendered a concurring opinion in which he stated that if in fact the director had been deputized to represent its interest as a director on the board the other partners would be liable for such short swing profits. Relying heavily on the *Rattner* case, the circuit court majority in the present case brushed aside as dicta Hand's theory of deputization. As makeweight, and probably to protect themselves in the event of an appeal, the majority insisted that even if Hand's theory were correct it would not apply to the facts involved here since no deputization had occurred. Justice Clark's vigorous dissent relied on concepts of partnership law which hold that one partner must be charged with knowledge of the actions of the others. Insisting that the majority of the circuit court as well as the majority decision in *Rattner* had placed an erroneous interpretation on the legislative history of the Securities Exchange Act he claimed the change from the earlier drafts indicated only that Congress favored an automatic application of the act without having to prove the partner's intent.[18] The theory of the dissent is that the clause was eliminated so as to avoid the necessity of proof and merely apply the objective test of whether or not one actually used inside information.

It would appear that attempting to discover the true and significant legislative intent from the failure of Congress to pass the Act in its original form is at best a hazardous task. There are many hidden factors which will operate constantly to force concessions and compromises in our legislative process. Here there seem to be two equally plausible interpretations of what that intent was. The majority insists that Congressional failure to pass the original draft, which would have imposed liability upon anyone securing information from an insider, evidenced a clear intent to limit the law's sphere of liability. Equally persuasive is the position that history really points the other way and in favor of an automatic application of the statute without proving the parties' intent. Further, the failure of Congress to act in the relatively short eight year period following *Rattner* is also of little help. It may be indicative of nothing more than the lack of a strong advocate to push for the necessary changes or that other pressing business has delayed any action by Congress. Any inference of legislative intent from Congressional inaction has been held a nebulous process by the Supreme Court itself.[19]

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[17] *Id.*, at 566.
[18] *Blau v. Lehman, supra* note 13, at 794.
[19] James v. Liberty Glass Co., 332 U.S. 524 (1948).

Congress is not required to make an affirmative move every time a lower court indulges in an erroneous interpretation of a statute in order to prevent the application of the doctrine of legislative acquiescence. Lower federal court decisions have likewise held that where Congress has not re-enacted a specific clause of a statute after administrative or judicial construction but has merely remained silent the inference that Congress has thereby approved such construction is not of much weight.[20]

In the present case the Court refused to overrule the trial court's fiindings of fact which had been affirmed by the court of appeals. Such findings were felt not to be clearly erroneous.[21] But the court did differ from the *Rattner* precedent in one important respect. It accepted Learned Hand's concurring opinion from *Rattner,* which advocated that a partnership could be a director within the contemplation of the Act where deputization had occurred. In so holding the Court would seem to have gone as far as they presently can. Having failed to reverse *Rattner* they did leave a hook upon which liability might attach where the plaintiff stockholder is able to prove an agency relationship. As to large investment partnerships, this case has destroyed any hope of imposing liability merely by proving that a fellow partner was a director and that short swing profits were made. But neither has 16(b) been entirely destroyed as would have followed an absolute reliance on the *Rattner* principle. It would seem entirely likely that in future cases the district courts will be more prone to find deputization under fact situations similar to these, now that the theory has been accepted.[22] At least it will be the job of the attorney to so argue if he maintains any hope of recovering short swing profits from a partnership under 16(b) of the Securities Exchange Act of 1934. In future cases which are so argued, should the courts continue to find no agency where the partners of the director realize short swing profits after consultation with the partner director, it would then truly be a dilution of the fiduciary principle that Congress wrote into Section 16 of the Act.

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[20] Fleming v. Moberly Milk Products Co., 160 F. 2d 259 (1947); Mitchell v. C.I.R., 300 F. 2d 533 (1962).

[21] *Blau v. Lehman, supra* note 15, at 82 S. Ct. 452.

[22] Consider the following language which is used in interpreting a fact situation in an action under a different statute but which has some pertinence to this reasoning:

". . . substantial fees are also obtained by Lehman Brothers from merger negotiations. Profits from the fees are shared by the partners. Section 409(a) companies, with Lehman Brothers partners as directors, need and use both types of services, and the partner directors seek such business for the partnership. *In doing so they act as representatives of the partnership.* (Italics added.) It follows that they act as representatives of fellow partners, some of whom are directors of air carriers. Is this representation within the meaning of the statute? Does Mr. Thomas, to use his case as illustrative, who is a Lehman Brothers partner and also a director of National Airlines, represent, as director of National Airlines, Mr. Lehman, another Lehman Brothers partner and director of Pan American? We think that the affirmative answer of the Board should not be disturbed. . . ." Lehman v. Civil Aeronautics Board, 209 F. 2d 289, 292-294 (1953).

Therefore, at present a partnership is not subject to the provisions of Section 16 if one of its partners is a director of a corporation unless deputization is proven. This imposes a difficult burden of proof in an action against such a partnership to recover short swing profits. Although inequitable on its face, the courts may balance the scales of justice in the future by making a more liberal and common sense appraisal of evidence indicating deputization in fact. If in fact such a liberal approach is not followed it will then be incumbent on Congress to act, if any teeth are to remain in the Act. Likewise, only Congressional amendment of 16(b) will impose liability upon a partnership for short swing profits without proof of deputization where one of its members is a director of the company at whose expense the partnership so profited.

For comparison purposes, it might be pointed out that the courts did not allow one other devastating wedge to be driven into the Act. Namely, the attempt of the partner-director to waive his right to any profit made by the partnership from the purchase of such stock and thus disclaim any individual liability for his proportionate share. This scheme was disallowed under the theory that such profits were nevertheless in contemplation of law realized by him. The court of appeals felt that allowing such waiver would be too wide a breach in the intent of the law.[23] It might be questioned why the Court of Appeals wasn't equally concerned with the breach in the intent of the law which they were prepared to allow in freeing the partnership from any liability.

In the final analysis the Supreme Court may have closed the breach substantially when it accepted the deputization theory. Only Congressional action or federal courts concerned with preserving the intent of the law and using deputization as a foothold can in fact save the Act. Failure to do so will

> leave a large and unintended loophole in the statute—one substantially eliminating the great Wall Street Trading firms from the statute's operation.[24]

DONALD E. MAYEW

Negligence—Abolition of the Defense of Municipal Immunity—An action was brought on behalf of a minor by her guardian ad litem against the City of Milwaukee to recover damages for personal injuries sustained while playing on a City playground. The minor's father joined in the action to recover damages for medical expenses and for the loss of her society and companionship. The plaintiff, a three and one-half year old child was playing on a playground known as a "tot-lot," operated by the City of Milwaukee for the use and enjoyment of

[23] *Blau v. Lehman, supra* note 13, at 791.
[24] *Blau v. Lehman, supra* note 13.