SECURITIES

by A. Michael Hainsfurther *

During the survey period, the Fifth Circuit decided six significant cases which affected three major areas of securities law.

I. SECURITY TRANSACTIONS

A. *Security: A Question of Law or Fact*

In a court proceeding in which a jury is involved, it is well settled that the judge is to decide questions of law, and the jury is to decide questions of fact. However, as to any given issue, there is always room for a difference of opinion as to whether a particular question is one of law or one of fact. Hence, in any jury trial, a determination must be made as to which questions constitute "questions of law" to be decided by the trial judge, and which questions constitute "questions of fact" to be decided by the jury.[1]

This issue arose in *United States v. Johnson*,[2] a criminal case in which the Fifth Circuit ruled that while the determination of what constitutes a question of fact and what constitutes a question of law is often a matter of discretion for the trial court, there are some issues which, "as a matter of law," involve questions of fact to be decided by the jury.[3] The court noted that it is the job of the jury in a criminal trial to determine if the defendant is guilty. Because the question of whether a particular instrument is a security is often an ultimate issue in any criminal securities prosecution, this is a question of fact for the

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1. United States v. Johnson, 718 F.2d 1317, 1321 n.10 (5th Cir. Oct. 1983) (en banc).

2. 718 F.2d 1317.

3. *Johnson* is a criminal law case which does not involve either the Securities Act of 1933 or the Securities Act of 1934 (collectively the "Securities Acts"), however, the principles in this case are likely to be applicable by analogy to both civil and criminal securities cases brought under the Securities Acts. Several cases involving the Securities Acts were relied upon by Judge Williams in his dissenting opinion in this criminal case, 718 F.2d, 1317, 1332 (1983 5th Cir.).

jury.[4] In *Johnson*, the defendant was charged with the interstate transportation of a counterfeit security.[5] The document involved was a gold certificate contract purporting to require the delivery of 17,000 ounces of gold stored in a bonded warehouse to a named recipient.[6]

One of the issues presented on appeal was whether the district court acted properly in instructing the jury that a particular document was a security as a matter of law.[7] In reversing the trial judge on this point, the Fifth Circuit, relying upon one of its previous decisions,[8] held that although it is the duty of the court to instruct the jury on the legal principles applicable to the determination of whether a particular document is a security, it is within the jury's exclusive province to apply the law to the facts and determine whether the document involved in a particular transaction is in fact a security.[9]

The court's opinion clearly states that it is the duty of the judge to provide instructions to the jury regarding the definition and that the jury is then to decide whether the particular piece of paper fits the definition; the decision, however, is clouded by a footnote.[10] According to the footnote, the question of whether a generic type of document, such as a traveler's check or an equipment lease, may come within the statute's prohibition is one of law.[11] However, the footnote

4. *Id.* at 1322.
5. *Id.* at 1319.
6. *Id.* at 1318.
7. *Id.*
8. Roe v. United States, 287 F.2d 435 (5th Cir.), *cert. denied*, 368 U.S. 824 (1961).
9. 718 F.2d at 1318.
10. *Id.* at 1321 n.13.
11. The distinction is similar to the Fifth Circuit's approach taken in Daily v. Morgan, 701 F.2d 496 (5th Cir. 1983) for the application of the test ("Howey Test") for determining the existence of a security as set forth in SEC. v. W.J. Howey Co., 328 U.S. 293 (The *Howey* test is set forth at *infra* note 33 and accompanying text.) In *Daily*, the Fifth Circuit determined that the Howey Test did not apply to an instrument having the typical characteristics of stock. *See infra* note 41 for a discussion of the typical characteristics of stock. For purposes of the criminal issues which were facing the court, the definition of security is provided at 18 U.S.C. § 2311 (1976), as follows:

> "Securities" includes any note, stock certificate, bond, debenture, check, draft, warrant, traveler's check, letter of credit, warehouse receipt, negotiable bill of lading, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate; certificate of interest in property, tangible or intangible; instrument or document or writing evidencing ownership of goods, wares, and merchandise, or transferring or assigning any right, title, or interest in or to goods, wares, and merchandise; or, in general, any instrument commonly known as a "security," or any certificate of interest or participation in, temporary or interim certificate for, receipt for, warrant, or right to subscribe to

is not clear as to the test for determining whether an instrument is a "generic" type of document which may be characterized by the court or whether it is another type of document which must therefore be submitted to the jury. Consequently, although a defendant in a criminal securities prosecution might find some comfort in the *Johnson* opinion, the decision itself is not all inclusive. Even though the court was willing to expand in part the jury's province in determining whether an instrument is a security, it is clear that the discretion of the trial court in this regard has not been entirely eliminated and that there are certain types of instruments which are apparently per se within the definition of the term security.

B. *Purchase or Sale Defined*

In order to maintain a private right of action under section 10(b) of the Securities Exchange Act of 1934[12] (the Exchange Act), and under rule 10b-5 (collectively 10(b)),[13] there must have been a purchase or sale of a security.[14] In *Keys v. Wolfe*,[15] the Fifth Circuit was presented with the issue of whether the modifications of security holders' obligations to third parties under a management contract, constituted a purchase and sale of a security within the meaning of section 10(b).[16] The plaintiffs were holders of investment contracts relating to pecan orchards operated by the defendant, Wolfe Pecanlands, Inc. (the Corporation).[17] The Corporation acquired undeveloped property, subdivided it into tracts, and sold those tracts to purchasers in a two-part integrated transaction. The first part was a land sales contract and the second part was a tree growing and orchard management contract.[18] The management contract provided that the Corporation was to pay for the out-of-pocket management costs, including irrigation expenses initially, but would be allowed to reimburse itself from the gross receipts realized from the sale of an-

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or purchase any of the foregoing, or any forged, counterfeited, or spurious representation of any of the foregoing;

12. 15 U.S.C. § 78j(b) (1982).

13. 17 C.F.R. § 240 10b-5 (1984).

14. Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723 (1975). Other elements which must be established prior to recovery are: material misrepresentation, scienter, reliance, diligence, and injury. Siebel v. Scott, 725 F.2d 995, 1000 (5th Cir. Feb. 1984), *cert. denied*, 52 U.S.L.W. 3891 (U.S. June 11, 1984) (No. 83-1742).

15. 709 F.2d 413 (5th Cir. July 1983).

16. *Id.* at 415.

17. *Id.* at 414.

18. *Id.* at 415.

nual crops, or, if those receipts were inadequate, from the proceeds of the sale of crops in subsequent years.[19] The plaintiffs alleged that, in order to induce the plaintiffs to release the Corporation from the irrigation arrangement described above and to enter into a different arrangement, the defendants failed to disclose certain material facts in a memorandum.[20] The new arrangement consisted of placing the property owned by the plaintiffs within a water control and improvement district.[21] The water control district is a political subdivision of the State of Texas and according to the court, the consequences of such arrangement were that, in lieu of having no personal obligation for irrigation costs as in the original agreement, the plaintiffs became personally liable for water assessments or taxes, and his tract of land became subject to potential liens for the unpaid amounts of such assessments or taxes and to the risk of foreclosure and sale if they remained unpaid.[22]

The specific question before the court was whether the substitution of the management contract between the parties was a transaction involving the purchase or sale of a security and thus, a transaction creating a potential cause of action under section 10(b).[23] Relying on its opinion in *Rathborne v. Rathborne*,[24] the court held that the trial judge erred in dismissing the particular count of the complaint without first determining whether there had been "a significant change in the nature of [the] investment or in [the plaintiff's] investment risks [so] as to amount to a new investment."[25] The court concluded that the decision of whether the personal liability for water district taxes and the possibility of the plaintiffs' property being subjected to liens constituted a significant change in the nature of the investment or in the investment risks and could not properly be made

19. *Id.*

20. *Id.* at 416.

21. *Id.*

22. 709 F.2d at 416. *See* Sears v. Colorado River Municipal Water Dist., 487 S.W.2d 810, 812 (Tex. Civ. App.—Eastland 1972, writ ref'd n.r.e.); TEX. WATER CODE ANN. §§ 55.603 & 55.604 (Vernon 1972) (repealed 1982); TEX. TAX CODE ANN. §§ 32.01 & 32.07 (Vernon 1982).

23. 709 F.2d at 416.

24. 683 F.2d 914 (5th Cir. 1982). In *Rathborne*, the court stated that "the core issue is whether the transaction has transformed the plaintiff into the functional equivalent of a purchaser or seller—has the plaintiff been forced to exchange his stock for shares representing a participation in a substantially different enterprise?" *Id.* at 920. *See Survey, Securities, Fifth Circuit Symposium*, 15 TEX. TECH L. REV. 277, 281-85 (1984).

25. 709 F.2d at 417.

in a pretrial motion.[26] The court impliedly recognized that an actual purchase and sale requirement can be met by a modification of the investor's obligations, even though no new investment of money occurs.

The court's decision is an extension of the principle it espoused in *Rathborne*.[27] In *Rathborne*, actual stock was exchanged in connection with a corporate reorganization.[28] In this case, although no actual transfer occurred, the terms of the contract were modified. Because it is possible that these modifications could have changed the nature of the plaintiffs' investment, it is also possible that the defendants' misrepresentations or omissions which induced the modifications could be a violation of section 10(b). Practitioners should be aware of this possible liability when any modifications to an agreement governing an investment are made. Because such modifications might be considered a purchase or sale under section 10(b), they might also constitute a sale under the Securities Act of 1933 (the 1933 Act) and require registration or exemption therefrom.[29]

C. *Sale of Business Doctrine*

The term "security" is defined in the 1933 Act[30] and the Exchange Act[31] to include various types of instruments, including an investment contract. The Supreme Court in *SEC v. W.J. Howey Co.*,[32] defined an investment contract as "a contract, transaction or

26. *Id.* The defendants in *Keys* made a Rule 12(b)(6) motion to dismiss for failure to state a claim. *See supra* note 25 and accompanying text. The district court dismissed a portion of the plaintiffs' complaint based on this motion. 709 F.2d at 415.

27. 683 F.2d 914.

28. *Id.* at 916.

29. *See* 15 U.S.C. § 77(e) (1982).

30. 15 U.S.C. § 77b (1982) provides in part:

> When used in this subchapter, unless the context otherwise requires—
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> (1) The term "security" means any note, stock, treasury stock, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, . . . or, in general, any interest or instrument commonly known as a "security," or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing.

Id.

31. 15 U.S.C. § 78c(10) (1982) provides substantially the same definition as that in the Securities Act of 1933.

32. 328 U.S. 293 (1946).

scheme whereby a person invests his money in a common enterprise and is led to expect profits solely from the efforts of . . . a third party . . . ."[33] The Fifth Circuit has held that the sale of one hundred percent of the stock of a corporation involved the sale of a security for purposes of section 10(b) of the Exchange Act, determining that the *Howey* test was inapplicable to instruments having the typical characteristics of stock.[34] Other circuits have adopted the "sale of business doctrine" which in effect applies the *Howey* test to all securities transactions. These courts have held that when a purchaser acquires all of the stock of a company, the purchaser is not making an investment with the expectation of profit solely from the efforts of others, but is instead acquiring assets which the purchaser will control.[35]

In *Siebel v. Scott*,[36] the Fifth Circuit was presented with the issues of whether limited partnership interests were securities and whether the transaction in which such interests were sold constituted the sale of securities.[37] The plaintiffs, owners of limited partnership interests, alleged that the defendants fraudulently induced them to sell their limited partnership interests to a corporation controlled by one of the defendants, Scott, and that the assets of the former limited partnership were placed in a new limited partnership with an entity controlled by Scott as the general partner which sold the new limited partnership interests at a large profit.[38] The defendants argued that the sale by the original limited partners of their limited partnership interests to one of the defendant entities did not constitute the sale of a security because it was, in essence, the transfer of the assets of the limited partnership.[39] This was an apparent attempt to classify the transaction within the "sale of business doctrine."

In response to these arguments, the court stated that its holding in *Daily v. Morgan*,[40] in which it had earlier rejected the sale of business doctrine, was applicable only to transactions involving ordinary

33. *Id.* at 298-99 (setting forth what is known as "the *Howey* test"). *See Survey, Securities, Fifth Circuit Symposium*, 12 TEX. TECH L. REV. 319, 319-26 (1980).

34. Daily v. Morgan, 701 F.2d 496, 497 (5th Cir. 1983).

35. *See* Thompson, *The Shrinking Definition of a Security: Why Purchasing All a Company's Stock Is Not a Federal Security Transaction*, 57 N.Y.U.L. REV. 225 (1982); *Survey, Securities, Fifth Circuit Symposium*, 15 TEX. TECH L. REV. 277, 279-81 (1984).

36. 725 F.2d 995 (5th Cir. Feb. 1984), *cert. denied*, 52 U.S.L.W. 3891 (U.S. June 11, 1984) (No. 83-1742).

37. *Id.* at 998.

38. *Id.* at 997.

39. *Id.* at 999.

40. 701 F.2d 496.

stock.[41] In *Daily*, the Fifth Circuit determined that the *Howey* test did not apply to instruments having all the typical characteristics of stock and that the sale of business doctrine was applicable only when the *Howey* test was used.[42] After noting the discrepancies among the circuits on the issue, the court stated, "[i]t is plain, then, that our rejection of the 'sale of business' rule for corporate stock is of no assistance to the investors here, whose interests, if they are securities at all, are best described as investment contracts."[43]

Applying the *Howey* test, the court determined that there was no evidence that any of the original limited partners planned or desired to participate in the operation of the business of the original limited partnership, that the investors were relying upon the entrepreneurial efforts of the defendants for profit "right through to the moment of sale" and that, as such, the limited partnership interests were securities in the hands of the investors.[44] This was the result notwithstanding the fact that, once the interests had been purchased by the defendants, the interests were no longer securities.[45] Noting that the partnership interests changed character at the moment of sale, the court concluded that "transactions involving the sale of an interest in a venture which is a security because it is an investment contract can be Janus-faced—simultaneously looking toward and away from status as a security."[46]

The court makes it clear that its rejection of the sale of business doctrine and its corresponding unwillingness to apply the *Howey* test apply only to ordinary corporate stock. In transactions involving an investment contract, the Fifth Circuit applies the *Howey* test.

In applying the *Howey* test, the court notes that a limited partnership interest could be a security in the hands of the seller but perhaps not in the hands of the purchaser; that is, the characterization of an interest can vary with the relationship of its holder to the venture. This determination should be compared to the language in *Daily*. In that case, the Fifth Circuit, rejected the sale of business doctrine stat-

41. 725 F.2d at 999. The typical characteristics of stock listed by the Supreme Court in United Hous. Found., Inc. v. Forman, 421 U.S. 837 (1975) include the right to receive dividends, the ability to negotiate, the right to pledge or hypothecate, the right to vote, and the possibility that the stock will appreciate in value. *Id.* at 851.

42. 701 F.2d at 499-500.

43. 725 F.2d at 999.

44. *Id.*

45. *Id.*

46. *Id.* at 999-1000.

ing that "the sale of business rule could lead to the anomolous [sic] and asymmetrical result that sellers would have protection under the securities laws but the purchaser would not."[47] The decision in *Siebel* does not necessarily indicate that the Fifth Circuit is backing away from its position as stated in *Daily*. However, it does undercut one of the arguments put forth by the court for rejecting the sale of business doctrine.

II. REMEDIES

A. *Arbitration*

In *Wilko v. Swan*,[48] the Supreme Court held that parties can seek relief in federal court for claims arising under the 1933 Act despite the parties' prior agreement to arbitrate.[49] The importance of maintaining the remedies under the Exchange Act was deemed to outweigh the advantages of arbitration.[50] The Fifth Circuit has extended the holding of *Wilko* to include claims arising under the Exchange Act.[51]

In *Smoky Greenhaw Cotton Co. v. Merrill Lynch Pierce Fenner & Smith, Inc.*,[52] the Fifth Circuit was faced with the issue of whether arbitration should be denied when the claims arising under the Exchange Act were intertwined with claims arising under the Commodities Exchange Act.[53] The plaintiff, an investor, had two separate trading accounts with the defendants; a brokerage house and its employee.[54] One account was a securities trading account and the other account was a commodities trading account.[55] The plaintiff alleged that the employee of the brokerage house had fraudulently used funds from the plaintiff's securities account for unauthorized trading in its commodities account and asserted claims under the Exchange Act, the Commodities Exchange Act, and various state law claims.[56]

When the plaintiff opened the commodities account, an agree-

47. 701 F.2d at 504.
48. 346 U.S. 427 (1953).
49. *Id.* at 438.
50. *Id.*
51. *See* Sawyer v. Raymond, James & Assoc., 642 F.2d 791, 792 (5th Cir. 1981); Sibley v. Tandy Corp., 543 F.2d 540, 543 n.3 (5th Cir. 1976), *cert. denied*, 434 U.S. 824 (1977).
52. 720 F.2d 1446 (5th Cir. Dec. 1983).
53. 7 U.S.C. § 1 (1982). The Commodities Exchange Act is separate from the Exchange Act but is closely related.
54. 720 F.2d at 1447.
55. *Id.*
56. 720 F.2d at 1447.

ment providing for arbitration was signed[57] which contained the requisite notice[58] in block letters above the signature line.[59] The district court granted the motion for a stay pending arbitration and the plaintiff appealed.[60] The Fifth Circuit vacated the stay and remanded the case to the district court.[61] The Fifth Circuit determined that the holding in *Wilko* does not apply to cases having causes of action solely under the Commodities Exchange Act.[62] The court refused to follow two district court cases,[63] finding their reasoning unpersuasive.[64] The court reasoned that the decision in *Wilko* was based upon a congressional determination which is contained, at least by implication, in the Exchange Act and the 1933 Act.[65] Because the Commodities Exchange Act specifically provides a notice provision which must be included in all agreements to arbitrate,[66] the court determined that congressional intent was to allow for arbitration as a dispute resolution mechanism in cases arising under the Commodities Exchange Act.[67] The court distinguished its holding in *Sibley v. Tandy Corp.*[68] by stating that in that case "the securities law claims and contract claims were not intertwined in a manner justifying a denial of arbitration of the contract claims."[69] In *Smoky Greenhaw Cotton Co.*, the Fifth Circuit noted that a determination of whether the actions of the defendants constituted commodity trading would "likely go many steps toward" determining whether there had also been improper use of the securities account. As a result, the securities claims were found to be so intertwined with the nonsecurities claims that the policy espoused in *Wilko* precluded arbitration of even the nonsecurities

57. *Id.* at 1448.

58. *Id.* at 1450 n.8. The language required has been modified. *See* 17 C.F.R. 180.3(b)(6) (1984).

59. 720 F.2d at 1450 n.9.

60. *Id.* at 1448.

61. *Id.* at 1451.

62. *Id.* at 1449-50.

63. Milani v. Conti Commodity Servs., 462 F. Supp. 405 (N.D. Cal. 1976); Breyer v. First Nat'l Monetary Corp., 548 F. Supp. 955 (D.N.J. 1982). *See also* Marchese v. Shearson Hayden Stone, Inc., 734 F.2d 414 (9th Cir. 1984); Byrd v. Dean Witter Reynolds, Inc., 726 F.2d 552 (9th Cir. 1984), *cert. granted*, 52 U.S.L.W. 3891 (U.S. June 11, 1984) (No. 83-1708).

64. 720 F.2d at 1449.

65. *Id.*

66. 17 C.F.R. § 180.3(b)(6) (1984).

67. 720 F.2d at 1449.

68. 543 F.2d 540 (5th Cir. 1976), *cert. denied*, 434 U.S. 824 (1977).

69. 720 F.2d at 1448.

claims.[70]

The court's decision is important for two reasons. First, it confirms the court's commitment to the rule precluding arbitration in securities cases. Second, it reflects the willingness of the court to permit a waiver of statutory remedies in certain instances. Although the court was not presented with the issue of an arbitration proceeding solely upon a Commodities Exchange Act issue, it stated that such cases would be subject to arbitration.[71] Nevertheless, practitioners should be aware of the court's strict views on the subject and should advise their clients of the potentially limited utility of savings provisions such as arbitration clauses in cases which involve both commodities and securities.

B. *Implied Causes of Action*

Federal courts have implied a number of private causes of action under the federal securities laws[72] even though the 1933 Act and the Exchange Act each provide several express private remedies for persons injured in securities transactions.[73] In *Herman & MacLean v. Huddleston*,[74] the Supreme Court confirmed that an implied private remedy exists under section 10(b) and rule 10b-5 of the Exchange Act for fraud committed in connection with the purchase or sale of a security even when an express remedy is available under Section 11[75] of the 1933 Act.[76] The question of whether an implied remedy is available under section 10(b) when there also exists an express remedy under other provisions of the Exchange Act or the 1933 Act is unclear.[77]

In *Chemetron Corporation v. Business Funds, Inc.*,[78] the Fifth Circuit upheld the district court's decision to grant an implied cause

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70. *Id.*

71. *Id.* at 1449.

72. The most common provisions under which these remedies have been allowed are §§ 10(b), 13, and 14(a) of the Exchange Act. 15 U.S.C. §§ 78j(b), 78m (1982).

73. Express civil remedies are set forth in §§ 11, 12, and 15 of the 1933 Act. 15 U.S.C. §§ 77k, 771, 77o (1982). Express civil remedies are set forth under §§ 9, 16, and 18 of the Exchange Act. 15 U.S.C. §§ 78i, 78p, 78r (1982).

74. 459 U.S. 375 (1983).

75. 15 U.S.C. § 77k (1982).

76. 459 U.S. at 387.

77. *See id.* at 379; Chemetron Corp. v. Business Funds, Inc., 682 F.2d 1149, 1157-58 (5th Cir.), *vacated and remanded*, 103 S. Ct. 1245 (1983); *See Survey, Securities, Fifth Circuit Symposium*, 15 TEX. TECH L. REV. 277, 289-290 (1984).

78. 718 F.2d 725 (5th Cir. Oct. 1983).

of action under section 10(b) when an express remedy was available under section 9(a)[79] of the Exchange Act.[80]

In its first decision which was issued prior to the Supreme Court's decision in *Huddleston*, the Fifth Circuit denied Chemetron's claim for civil damages under section 10(b).[81] Although Chemetron had filed suit on the theory of alleged stock manipulations, the court found that section 9 was the express statutory remedy for the kind of manipulation involved. The court reasoned that to allow a remedy under the less restrictive requirements of section 10(b), when a jury had found the facts lacking for a remedy under section 9, would constitute a nullification of the requisites of the express remedy provided in section 9(a) which requires an additional element to establish liability.[82] In the first *Chemetron* decision, the Fifth Circuit distinguished the *Huddleston* case because that case involved section 11 of the 1933 Act[83] and section 10(b) was determined to contain additional and different elements of an offense creating the civil remedy.[84]

In its second opinion, the Fifth Circuit, bowing to the intervening Supreme Court decision in *Huddleston*, determined that the distinction was not relied upon by the Supreme Court in its review of *Huddleston* and, therefore, such a distinction should not preclude recovery under a 10(b) cause of action in this case.[85] Judge Gee, in his dissenting opinion, found fault with allowing recovery for an implied cause of action requiring a lesser showing for relief than the provision written by Congress to govern such conduct.[86] He felt that the result of the majority's opinion was to substitute and nullify the section 9 cause of action and its incumbent procedural restrictions provided by Congress.[87]

An assessment of the decision depends upon the effect to be given to the *Huddleston* case. If the decision in *Huddleston* was meant to provide that an implied cause of action exists under section 10(b), irrespective of any express remedies available, then the decision in

79. 15 U.S.C. § 78i (1982).

80. 718 F.2d at 728.

81. Chemetron Corp. v. Business Funds, Inc., 682 F.2d 1149 (5th Cir. 1982), *vacated and remanded*, 103 S. Ct. 1245 (1983).

82. *Id.* at 1165.

83. 15 U.S.C. § 77k (1982).

84. 682 F.2d at 1159-60.

85. 718 F.2d at 727-28.

86. *Id.* at 729 (Gee, J., dissenting).

87. *Id.* Note that a rehearing en banc was requested and granted, but the case was settled prior to rehearing.

Chemetron is correct. However, if *Huddleston* is to be read, as argued by Judge Gee, to apply only when the elements of an express remedy do not exist and when 10(b) requires additional and different elements than those required by the express remedies, then the decision is incorrect.

C. *Disgorgement of Short Swing Profits*

Section 16(b) of the Exchange Act[88] allows an issuer to recover any profit realized by an officer, director, or beneficial owner of ten percent or more of the issuer's stock in connection with any purchase and sale of the issuer's stock occurring within any six month period, irrespective of the intention of the shareholder involved.[89] The Supreme Court provided a narrow exception to this otherwise objective statute in *Kern County Land Co. v. Occidental Petroleum Corp.*[90] for a "borderline" transaction. The Supreme Court said, that in such a case, the courts should consider whether the insider had or was likely to have access to inside information.[91]

In *Texas International Airlines v. National Airlines, Inc.*,[92] Texas International Airlines ("TI") sought, in a declaratory judgment action, to extend this theory to allow retention of profits made in the purchase and sale of the stock of National Airlines, Inc. ("National").[93] In an attempt to gain control of National, TI, which was already a beneficial owner of more than ten percent of National's common stock, purchased 121,000 shares of National's common stock on March 14, 1979, in open-market brokerage transactions. After a competing bidder, Pan American World Airways, Inc. ("Pan Am"), acquired control of National, TI sold 790,700 shares of National's common stock on July 30, 1979, for cash to Pan Am.[94] At that time, a merger agreement between National and Pan Am dated September 6, 1978, had been entered into and approved by National's

88. 15 U.S.C. § 78p(b) (1982).

89. *Id.*

90. 411 U.S. 582 (1973).

91. *Id.* at 594, 594 n.26. Occidental Petroleum Corp. ("Occidental") was the corporate "insider" in *Kern County*. Occidental owned more than ten percent of the shares of stock of Kern County Land Company and then, pursuant to a merger, exchanged its shares of stock for those of the acquiring corporation. *Id.* at 584-90.

92. 714 F.2d 533 (5th Cir. Sept. 1983), *cert. denied*, 104 S. Ct. 1326 (1984).

93. *Id.* at 535.

94. *Id.*

shareholders.[95] Pursuant to the merger agreement, TI, as a shareholder of National, would have received $50 per share when the merger closed. However, TI made its sale to Pan Am prior to the closing of the merger.[96]

TI asserted a defense of equitable estoppel arguing that its purchase and sale of National's stock should not be governed by section 16(b) because the issuer and purchaser were the same person (Pan Am and National merged) and equity should not allow National to complain about TI's profits in a transaction to which Pam Am voluntarily agreed.[97] In support of its argument, TI relied upon *Regional Properties v. Financial & Real Estate Consulting Co.*[98] for the proposition that equitable remedies created by the federal securities laws may be barred by equitable defenses.[99] The Fifth Circuit distinguished *Regional Properties* on the grounds that it involved section 29(b) of the Exchange Act in a contract voiding (equitable) action and that the defendant had made misrepresentations and omissions at the time of entering into the contract.[100] Even if the equitable defenses were available, the court said that it was not sure that the equities favored TI because TI was aware of both the inevitable merger and the requirements of section 16(b).[101]

TI also argued that the purpose of section 16(b) was not furthered by applying it to the situation because TI was not an insider, had no access to inside information, and because the situation involved a hostile takeover.[102] Relying upon the policy of the *Kern County* case, TI sought to extend the exception provided in that case for unorthodox or borderline transactions.[103] The Fifth Circuit distinguished the exception provided in *Kern County* by reasoning that that case involved a stock-for-stock merger as opposed to a traditional

95. *Id.*

96. *Id.*

97. *Id.* at 536-38.

98. 678 F.2d 552 (5th Cir. 1982).

99. 714 F.2d at 537.

100. *Id.*

101. *See id.* at 538 n.7 (noting that TI began negotiations with Pan Am only after Pan Am became a 51% shareholder of National and could thereby "force" shareholder approval of the merger agreement). The footnote also states that TI initiated the declaratory judgment action five days after its sale of stock. *Id.* Judge Garza, in his dissent, points out that the decision allows Pan Am to avoid a portion of its contract with TI requiring Pan Am to pay $50 per share and, consequently, is a windfall to Pan Am as the successor of National. *Id.* at 543.

102. *Id.* at 538.

103. *See supra* notes 90-91 and accompanying text.

cash-for-stock transaction. The court stated that stock-for-stock transactions do not have the voluntary nature of a cash-for-stock transaction in which TI was involved.[104] The Supreme Court expressly stated in *Kern County* that if Occidental had disposed of its shares of stock for cash before the merger (as took place in the TI case) such an act would have been subject to section 16(b). The involuntary nature of the Occidental exchange, together with the absence of a possibility for abuse of inside information, allowed for the exception.[105]

Section 16(b) states that it was enacted for the purpose of preventing the unfair use of information which may have been obtained by a statutory insider by reason of his relationship to the issuer.[106] The dissent relies upon this statement of purpose and the fact that both this case and *Kern County* involved hostile takeovers in which no inside information was available to the statutory insiders in support of the proposition that the *purpose* of 16(b) is not furthered by its application to the present transaction. The crux of the dissent's argument lies in the fact that, in both the *TI* and *Kern County* cases, no inside information was appropriated by the statutory insiders. Thus, the purpose of section 16(b), namely to prevent the unfair use of such appropriated information, is not served by its application to these cases. The dissent argued that the sale to a takeover company, even though for cash, should not be viewed as a traditional cash-for-stock transaction and should be categorized as an unorthodox transaction.[107]

Texas International sets forth a two-pronged test for determining when the exception to the literal language of section 16(b) for an unorthodox or borderline transaction will be allowed. The transaction must be involuntary and without the possibility for abuse.[108] The Fifth Circuit has in this case refused to depart from the literal language of section 16(b). Because this case presented facts which, had the court desired, could have supported a liberalized interpretation of section 16(b), it is not likely that any more liberal interpretations of section 16(b) will be forthcoming from the court in the near future.

104. 714 F.2d at 540.

105. 411 U.S. at 600.

106. 15 U.S.C. 78p(b) (1982).

107. 714 F.2d at 543.

108. *See supra* note 103 and accompanying text.

III. MEASUREMENT OF DAMAGES

The case of *Siebel v. Scott* [109] is significant not only because of its holding concerning the court's willingness to expand the definition of the term "security" when a cause of action would apparently otherwise be borderline, but also because of the flexible method the court used for the calculation of the damages. The court permitted recovery to be measured by disgorgement in addition to damages measured under the traditional out-of-pocket standard. The plaintiffs, owners of the original limited partnership interests, alleged that the defendant Scott persuaded them to sell their interests at a price lower than their fair market value, whereupon the assets of the first partnership were sold to a second partnership causing the first partnership, then owned by the defendants, to realize a large profit.[110] The *Siebel* court relied upon the formula set out previously by the Fifth Circuit in *Huddleston* that the traditional rule for damages in a 10(b) action[111] is the "so called" out-of-pocket rule.[112] The out-of-pocket rule allows as damages "the difference between the price received and the value of the securities at the time of the fraudulent transaction."[113] The *Siebel* court interprets out-of-pocket to permit the value placed on the securities at the time of the transfer to include price developments in the securities which occur after the transfer.[114] In addition, the court permits recovery to be measured by disgorgement of the profits received by a defendant when the defendant has defrauded the plaintiff in connection with the plaintiff's sale of securities and the defendant has resold the securities within a relatively short time.[115] The court pointed out that a limitation exists with respect to the profits a defendant will be required to relinquish. A plaintiff may not receive any

109. 725 F.2d 995 (5th Cir. Feb. 1984). This case has already been discussed in the materials relating to the sale of business doctrine in footnotes 30-47 and accompanying text.

110. *Id.* at 1001.

111. 10(b) refers collectively to 15 U.S.C. § 78j(b) (1982) and 17 C.F.R. § 240 10b.5 (1984). *See supra* notes 12-13 and accompanying text.

112. Huddleston v. Herman & MacLean, 640 F.2d 534, 555-56 (5th Cir. 1981), *aff'd in part and rev'd in part*, 459 U.S. 375 (1983).

113. 725 F.2d 995, 1001 (citing Alley v. Miramon, 614 F.2d 1372, 1387 (5th Cir. 1980)).

114. 725 F.2d at 1001 (citing Dupuy v. Dupuy, 551 F.2d 1005 (5th Cir. 1977) (citing with approval Myzel v. Fields, 386 F.2d 718 (8th Cir. 1967), *cert. denied*, 390 U.S. 951 (1968) and Janigan v. Taylor, 344 F.2d 781 (1st Cir. 1965), *cert. denied*, 382 U.S. 879 (1965))).

115. 725 F.2d at 1001. "The trend looks to defendant's profits, rather than to plaintiff's losses, in measuring damages." *Id.* Nelson v. Serwold, 576 F.2d 1332, 1338 (9th Cir.), *cert. denied*, 439 U.S. 970 (1978). The rule has also been adopted by the Supreme Court in Affiliated Ute Citizens v. United States, 406 U.S. 128, 155 (1972).

portion of the profits attributable to the defendant's "special or unique efforts . . . other than those for which he is duly compensated."[116] The court remanded the case to the district court for a determination of the damages to be awarded to the plaintiffs. The court counseled that the damages are to be equal to "the greater of the value of their interests at the moment of sale or the profit realized by JSA [a defendant] through the resale to the extent these profits are not attributable to Scott's [a defendant] entrepreneurial efforts."[117]

The court reached the right conclusion but seemingly combines the two separate remedies of disgorgement and the out-of-pocket rule. The disgorgement remedy is independent from the out-of-pocket damage standard. *Janigan v. Taylor*,[118] cited by the court as the pioneer of the disgorgement remedy for defrauded sellers of securities, stated that disgorgement is based upon the gain to the defendant. The out-of-pocket remedy is, however, based upon the harm to the plaintiff. Therefore, under the disgorgement approach set forth in *Janigan*, the plaintiff would be able to recover the defendant's profit even though that profit could not be included under an out-of-pocket measure because it would not necessarily have accrued to the plaintiff without the fraudulently induced sale.[119]

Seibel is a commendable move by the Fifth Circuit away from the narrow reading of its decision in *Huddleston* which limited the plaintiff to out-of-pocket damages. As *Seibel* confirms, relief can be based upon the defendant's unjust enrichment independently of an out-of-pocket recovery.

IV. CONCLUSION

In five of the cases surveyed, the decisions of the Fifth Circuit may be viewed as favoring the party alleged to have been injured in the securities transaction. In the *Chemetron* case, the court gave a liberal interpretation to the remedies available to an injured party, eschewing section 9 in favor of the less restrictive remedy under section 10(b). In *Texas International*, the court strictly interpreted section 16(b) in thwarting the defendant's attempt to have his

116. 725 F.2d at 1002 (quoting Nelson v. Serwold, 576 F.2d at 1338 n.3).

117. *Id.* at 1002.

118. 344 F.2d 781 (1st Cir.), *cert. denied*, 382 U.S. 879 (1965). *See* Thompson, *The Measure of Recovery under Rule 10-5: A Restitution Alternative to Tort Damages*, 37 VAND. L. REV. 349 (March 1984).

119. 344 F.2d 781.

transactions exempted based on the narrow exception to section 16(b) created in *Kern County*. These two seemingly incongruous methods of interpretation are easily reconciled if one assumes that the potential liability to which a defendant may be subject will be broadened by a liberal reading of the remedies available while any protective provisions available will be given a narrow interpretation. The cases in the current survey period indicate that the Fifth Circuit has returned to a relatively strong position of protecting parties who allege that they have been injured in a securities transaction.