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Securities Regulation-Application of Section 16(b) - Deputization - Liability for Short-Swing Profits After Directorship Terminated-Feder v. Martin Marietta Corp. 406 F.2d 260 (2d. Cir. 1969)

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Securities Regulation—APPLICATION OF SECTION 16(B)—DEPUTIZATION—LIABILITY FOR SHORT-SWING PROFITS AFTER DIRECTORSHIP TERMINATED. *Feder v. Martin Marietta Corp.*, 406 F.2d 260 (2d Cir. 1969).

The president of defendant corporation served as a member of Sperry Rand's Board of Directors from April 29, 1963 to August 1, 1963.[1] During that time, Martin Marietta purchased a large amount of Sperry Rand stock.[2] Shortly after Martin Marietta's president resigned his directorship on Sperry Rand's Board, the defendant corporation sold all of its Sperry stock.[3] Plaintiff contends that Martin Marietta was a director of Sperry Rand, within the meaning of section 16(b) of the Securities Exchange Act of 1934,[4] having deputized its president to represent it on Sperry's board. This action was brought to recover

1. Feder v. Martin Marietta Corp., 286 F. Supp. 937, 940 (S.D. N.Y. 1968), *rev'd*, 406 F.2d 260 (2d Cir. 1969), *petition for cert. filed*, 37 U.S.L.W. 3452 (U.S. May 16, 1969) (No. 1404, 1968-69 Term; renumbered No. 125, 1969-70 Term).

2. 406 F.2d at 263. Martin Marietta purchased 101,300 shares of Sperry stock between April 29, 1963 and August 1, 1963.

3. *Id.* Between December 14, 1962 and July 24, 1963, defendant corporation accumulated 801,300 shares of Sperry stock which was subsequently sold.

4. 15 U.S.C. § 78p(b) (1964):

> For the purpose of preventing the unfair use of information which may have been obtained by such beneficial owner, director, or officer by reason of his relationship to the issuer, any profit realized by him from any purchase and sale, or any sale and purchase, of any equity security of such issuer (other than an exempted security) within any period of less than six months, unless such security was acquired in good faith in connection with a debt previously contracted, shall inure to and be recoverable by the issuer, irrespective of any intention on the part of such beneficial owner, director, or officer in entering into such transaction of holding the security purchased or of not repurchasing the security sold for a period exceeding six months. Suit to recover such profit may be instituted at law or in equity in any court of competent jurisdiction by the issuer, or by the owner of any security of the issuer in the name and in behalf of the issuer if the issuer shall fail or refuse to bring such suit within sixty days after request or shall fail diligently to prosecute the same thereafter; but no such suit shall be brought more than two years after the date such profit was realized. This subsection shall not be construed to cover any transaction where such beneficial owner was not such both at the time of the purchase and sale, or the sale and purchase, of the security involved, or any transaction or transactions which the Commission by rules and regulations may exempt as not comprehended within the purpose of this subsection.

short-swing profits[5] realized by the defendant corporation from the sale of the stocks in question.[6]

The trial court found that the evidence failed to establish deputization and dismissed the action.[7] The Court of Appeals of the Second Circuit reversed, holding that the lower court had mistakenly interpreted the evidence,[8] that the defendant corporation was a director within the meaning of section 16(b), and that it must "disgorge" all short-swing profits realized from the Sperry stock it purchased during its directorship, even though the sale was made subsequent to the termination of that directorship.[9]

The purpose of section 16(b) is to prevent a ten percent beneficial owner, or a director or officer of an issuer of equity securities from unfairly using inside information which he may have obtained due to his relationship to the issuer.[10] Liability under this section is automatic[11] and does not depend upon proving the use of inside information.[12] Short-swing profits realized by one of the above classes are recoverable to the issuer.[13] The courts have tended to interpret section 16(b) liberally,[14] that is, "in ways that are most consistent with the legislative purpose." [15]

This trend toward liberal interpretation has given rise to the creation and acceptance of the theory of deputization which extends the Act to include persons not literally specified in section 16(b).[16] Deputization,

5. Short-swing profits are made from the purchase and sale or sale and purchase of a stock within six months. W. PAINTER, FEDERAL REGULATION OF INSIDER TRADING 24-25 (1968).

6. Securities Exchange Act of 1934 § 16(b), 15 U.S.C. § 78p(b) (1964), allows any owner of securities of the issuer to bring suit in the name of the issuer if the issuer refuses or fails to do so upon request.

7. 286 F. Supp. at 948.

8. 406 F.2d at 263. The court reviewed the facts and inferences of the case within the "unless clearly erroneous" standards of FED. R. CIV. P. 52(a) and, upon consideration of the entire evidence, found that the lower court had committed a reversible error in not finding deputization.

9. 406 F.2d at 266.

10. Securities Exchange Act of 1934 § 16(b), 15 U.S.C. § 78p(b) (1964).

11. 406 F.2d at 262.

12. W. PAINTER, *supra* note 5, at 12.

13. Securities Exchange Act of 1934 § 16(b), 15 U.S.C. § 78p(b) (1964).

14. *E.g.*, Ellerin v. Massachusetts Mutual Life Ins. Co., 270 F.2d 259, 263 (2d Cir. 1959); Smolowe v. Delendo Corp., 136 F.2d 231, 239 (2d Cir. 1943); Molybdenum Corp. of America v. International Mining Corp., 32 F.R.D. 415, 419 (S.D. N.Y. 1963); W. PAINTER, *supra* note 5, at 26.

15. 406 F.2d at 262.

16. *Id.* at 262-63.

as it relates to the issues discussed herein, occurs when a person is appointed to represent the interest of another[17] or to perform the duties of a director[18] for another.[19] The application of this concept to a case involving section 16(b) was first suggested by the concurring opinion in *Rattner v. Lehman*.[20] The Supreme Court, in *Blau v. Lehman*, by way of a dictum, recognized the possibility of applying deputization to a partnership.[21] In *Marquette Cement Mfg. Co. v. Andreas*, an action against a corporation charged with deputization was dismissed because the evidence did not warrant such a finding.[22] Thus, prior to the principal case, no business organization has been held to be a director by deputization in a section 16(b) case.[23]

Having classified Martin Marietta as a director, the court then had to resolve the novel issue of whether liability would be imposed on short-swing profits realized from stock purchased while it was a director but sold after the termination of the directorship.[24] Although the tenor of recent decisions has been to extend the scope of transactions included within section 16(b),[25] it was anticipated by some that liability in a

17. Rattner v. Lehman, 193 F.2d 564, 567 (2d Cir. 1952).

18. Blau v. Lehman, 368 U.S. 403, 410 (1962).

19. The lower court in *Feder* noted that the *Rattner* definition of "deputized to represent interest" is broader than the *Blau* definition of "deputized to perform a director's duties." 286 F. Supp. at 942 n.12. This observation raises the question of which of the two tests will be applied in future cases to determine deputization. The approach taken by the lower court was to apply the broader test first, for if the plaintiff's evidence fails to satisfy this test, then it necessarily follows that it will fail to sustain the narrower test. *Id.* at 942 n.13. The Court of Appeals applied the broader test. 406 F.2d at 265-66.

20. 193 F.2d 564, 567 (2d Cir. 1952). Judge Learned Hand, while agreeing with the majority that the partnership in that case did not come within the meaning of section 16(b), stated:

> I agree that § 16(b) does not go so far; but I wish to say nothing as to whether, if a firm deputed a partner to represent its interests as a director on the board, the other partners would not be liable. True, they would not even then be formally "directors"; but I am not prepared to say that they could not be so considered; for some purposes the common law does treat a firm as a jural person.

21. "No doubt Lehman Brothers, though a partnership, could for purposes of § 16 be a 'director' of Tide Water and function through a deputy . . .," 368 U.S. 403, 409 (1962).

22. 239 F. Supp. 962 (S.D.N.Y. 1965).

23. *Cf.* 6 HOUSTON L. REV. 568, 573 (1969).

24. 406 F.2d at 266.

25. *E.g.*, Adler v. Klawans, 267 F.2d 840 (2d Cir. 1959); Stella v. Graham-Paige Motors Corp., 232 F.2d 299 (2d Cir. 1956); Blau v. Allen, 163 F. Supp. 702 (S.D.N.Y. 1958).

Feder type of transaction would be precluded.[26] Following the rationale of *Andler v. Klawans*,[27] however, the *Feder* court concluded that the legislative intent of the Act was to include this type of transaction within the provisions of section 16(b) and that liability would follow.[28]

Feder v. Martin Marietta represents a new direction of the expansion of section 16(b) by judicial interpretation. The *Feder* court has broadened the transactions covered by this section's provisions as well as the classes of persons subject to its liabilities. These enlargements will undoubtedly affect many organizations and individuals as well as security practices in general.[29] The full impact of the *Feder* case, however, is not limited solely to these aspects of securities. By its decision, the *Feder* court has drifted into the often undefinable area between judicial review and judicial legislation. The court's entrance into the scope of authority of the Securities and Exchange Commission was complete with the reversal of a SEC rule[30] and the effect of its judicial legislation was evident. While the final outcome of *Feder* is as yet un-

26. Stella v. Graham-Paige Motors Corp., 232 F.2d at 305 (2d Cir. 1956) (Hincks, J., dissenting); 2 L. Loss, SECURITIES REGULATION 1061 (2d ed. 1961).

27. Adler v. Klawans, 267 F.2d 840 (2d Cir. 1959). The court imposed liability on short-swing profits realized from the sale of a corporation's stock by a director who was not a director at the time of purchase.

28. 406 F.2d at 268-69.

29. *See* 6 HOUSTON L. REV. at 579.

30. The *Feder* court invalidated SEC Rule X-16A-10, 17 C.F.R. § 240.16a-10 (1969) which reads:

> Any transaction which has been or shall be exempted by the Commission from the requirements of section 16(a) shall, in so far as it is otherwise subject to the provisions of section 16(b), be likewise exempted from section 16(b).

Section 16(a) prescribes the reporting requirements of beneficial owners, directors and officers. Prior to the *Feder* decision, Section 16(a) made no requirement of a report of transaction by a person who ceased to be in one of the above classes. Thus, by being exempted in section 16(a), Rule X-16A-10 would also exempt them from section 16(b) liability to relinquish profits from short-swing transactions.

The SEC has expressed its concurrence with the *Feder* decision by way of the Securities Exchange Act of 1934, Release No. 8697 (Sept. 18, 1969), 34 Fed. Reg. 15246 (1969), which is an amendment to rule 16A-1. Paragraph (e) of this amendment requires:

> Any person who has ceased to be a director or officer of an issuer which has equity securities registered pursuant to Section 12 of the Act, or who is a director or officer of an issuer at the time it ceased to have any equity securities so registered, shall file a statement on Form 4 with respect to any change in his beneficial ownership of equity securities of such issuer which shall occur on or after the date on which he ceased to be such director or officer, or the date on which the issuer ceased to have any equity securities so registered, as the case may be, if such change

certain,[31] it would seem likely that it will not be the final determination in the expansion of section 16(b).

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Domestic Relations—THE EFFECT OF MENTAL INCOMPETENCE IN DIVORCE PROCEEDINGS. *Crittenden v. Crittenden*, 210 Va. 76, 168 S.E.2d 115 (1969).

For more than two years Henry Crittenden had been separated from his wife as a result of her commitment for mental incompetence.[1] This separation was the grounds for which a Chancery court decree awarded Mr. Crittenden a divorce *a vinculo matrimonii*.[2] Evelyn Crittenden and her committee appealed.[3]

In reversing the chancery court, the Supreme Court of Appeals of Virginia held that for separation to be a ground for divorce under section 20-91(9) of the Virginia Code, the parties must be sufficiently competent to be cognizant of the separation.[4] One separated from his spouse as a result of commitment for mental incompetence is not, as a matter of law, capable of being conscious that a separation has occurred.[5]

In the absence of statute, the fact that a husband and wife live separate and apart, regardless of the length of time, is not a ground for divorce.[6] Approximately one half of the jurisdictions in the United

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shall occur within 6 months after any change in this beneficial ownership of such securities prior to such date. The statement on Form 4 shall be filed within 10 days after the end of the month in which the reported change in beneficial ownership occurs.

By this new rule, *Feder* type transactions are reportable under 16(a) and, therefore, subject by *statute* to section 16(b).

31. A petition for certiorari to the Supreme Court has been filed. 37 U.S.L.W. 3452 (U.S. May 16, 1969) (No. 1404, 1968-69 Term; renumbered No. 125, 1969-70 Term).

1. Crittenden v. Crittenden, 210 Va. 76, 168 S.E.2d 115 (1969). Evelyn Crittenden had been committed to Eastern State Hospital, Williamsburg, Virginia, on May 19, 1950, and was still confined at the time of this decision. *Id.* at 77, 168 S.E.2d at 115.

2. VA. CODE ANN. § 20-91(9) (Cumulative Supp. 1968):

> A Divorce from the bond of matrimony may be decreed:
>
> . . . .
>
> (9) On the application of either party if and when the husband and wife have lived separate and apart without any cohabitation and without interruption for two years. A plea of res adjudicata or of recrimination with respect to any other provision of this section shall not be a bar to either party obtaining a divorce on this ground.

3. 210 Va. at 77, 168 S.E.2d at 116.

4. *Id.* at 78, 168 S.E.2d at 116.

5. *Id.*

6. *E.g.*, McDougall v. McDougall, 5 Wash. 802, 803, 32 P. 749, 750 (1893).