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## **Weapons to Fight Insider Trading in the 21st Century: A Call for the Repeal of Section 16(b)**

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"Fault should be a requirement for punishment."

Benjamin N. Cardozo<sup>1</sup>

**WEAPONS TO FIGHT INSIDER TRADING IN THE 21ST CENTURY:  
A CALL FOR THE REPEAL OF SECTION 16(B)<sup>2</sup>**

by

Michael H. Dessent\*

Does it make legal sense that a corporate officer who bought and sold shares in his own company within a six-month period at an accounting loss, with no intent to deceive, can be sued to give up her nonexistent "profits"? Should the so-called aggrieved plaintiff be entitled to recover if he was not even a shareholder at the time of the defendant's stock trades and had never even heard of the corporation until his lawyer told him to buy that stock?<sup>3</sup> Should a judgment for that

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<sup>1</sup> BENJAMIN N. CARDOZO, *THE NATURE OF THE JUDICIAL PROCESS* (1921). Then Chief Judge Cardozo (later U.S. Supreme Court Justice), explained the position of the prestigious New York Court of Appeals in the context that criminal statutes should require some knowledge that a criminal act was morally wrong:

In the light of all these precedents, it is impossible . . . to say that there is any decisive adjudication which limits the word "wrong" in the statutory definition to legal as opposed to moral wrong. The trend of the decisions is indeed the other way. The utmost that can be said is that the question is still an open one. We must, therefore, give that construction to the statute which seems to us most consonant with reason and justice.

*People v. Schmidt*, 216 N.Y. 324, 338 (1915).

<sup>2</sup> Securities Exchange Act of 1934, § 16(b), 15 U.S.C. § 78p(b) (1994) [hereinafter *Section 16(b)*].

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<sup>3</sup> A case illustrating this principle is *Gratz v. Claughton*, 187 F.2d 46 (2d Cir. 1951), *cert. denied*, 341 U.S. 920 (1951).

In this decision the defendant was ordered to pay \$300,000 to the corporation for the "profits" he earned over several six-month periods. *Id.* at 52. In actuality he had incurred a taxable loss of \$400,000. The court followed *Smolowe v. Delendo Corp.*, 136 F.2d 231, 237 (2d Cir. 1943), which stated that to give section 16(b) its full effect, the calculation would be the shares with the lowest purchase price, matched against those with the highest sale prices. *Id.* at 237 & n.11. Thus, they would ignore any losses which may be actualized. *Id.* at 238.

plaintiff be allowed if he purchased only one share of stock in that corporation just before filing suit? What if he is seeking only a negligible share of the recovery himself, while his attorney in the action can receive several thousand dollars?<sup>4</sup>

Finally, is it legally "right"<sup>5</sup> that over 66 years of comprehensive securities litigation involving Section 10(b) of the Securities Exchange Act of 1934,<sup>6</sup> and its Rule 10(b)5,<sup>7</sup> have led to well-defined standards of such unique concepts of "duty," "breach," "scienter," "causation," "reliance," "misappropriation" and "materiality" for insider trading,<sup>8</sup> but none of that matters in a § 16(b) case?

It is the position of this paper that § 16(b)<sup>9</sup> needs to be repealed. That statute puts blame on innocent people and essentially legalizes champerty.<sup>10</sup> Adequate standards have been created by which culpability for insider trading can be determined and society protected.<sup>11</sup> Equally important, the high likelihood of champerty, and the total lack of merit and standing of most individual plaintiffs, coupled with the Supreme Court's recent *U.S. v. O'Hagan*<sup>12</sup> decision, give Congress a marvelous opportunity to repeal the statute while still carrying out its original legislative purpose.<sup>13</sup>

Sections I and II of this paper consist of an examination of Section 16(b)

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<sup>4</sup> *Magida v. Continental Can Co.*, 231 F.2d 843, 846-47 (2d Cir. 1956), *cert. denied*, 351 U.S. 972 (1956).

<sup>5</sup> For judicial definitions of that word in a criminal context, see *Tenement House Dept. v. McDevitt*, 215 N.Y. 160, 163 (1915); *People on Inf. of Price v. Sheffield Farms-Slawson-Decker Co.*, 225 N.Y. 25 (1918).

<sup>6</sup> 15 U.S.C. § 78j (1994).

<sup>7</sup> 17 C.F.R. § 240.10b-5 (1997).

<sup>8</sup> For the most recent U.S. Supreme Court decision discussing these terms, see *United States v. O'Hagan*, 521 U.S. 642 (1997).

<sup>9</sup> 15 U.S.C. § 78p(b) (1994).

<sup>10</sup> "A bargain between a stranger and a party to a lawsuit by which the stranger pursues the party's claim in consideration of receiving part of any judgment proceeds." NATHAN M. CRYSTAL, *PROFESSIONAL RESPONSIBILITY-PROBLEMS OF PRACTICE AND THE PROFESSION* 273 (1996). Also relates to general term of "maintenance"- "maintaining, supporting, or promoting the litigation of another." *See also* BLACK'S LAW DICTIONARY 157 (6th ed. 1991).

<sup>11</sup> *See generally* *United States v. O'Hagan*, 521 U.S. 642 (1997).

<sup>12</sup> *Id.*

<sup>13</sup> The U.S. Supreme Court has continuously struggled over the propriety of strict liability in criminal law. *See e.g.*, *United States v. Parks*, 421 U.S. 658 (1975); *United States v. Dotterweich*, 320 U.S. 277 (1943).

and the intent of Congress in establishing this section. It further discusses the policy behind Congress' allowance of non-owners of the security at the time of the "short swing" transaction to establish standing to sue by acquiring the security even after the alleged transaction has taken place.

Sections III through VI discuss the abuses by attorneys in making large profits in connection with Section 16(b) cases. In this section it will be shown that the practice of receiving such large attorney's fees is actually long-standing. *Gollust v. Mendell*<sup>14</sup> is the most recent case addressing this issue. However, there is a history of cases which date back as early as the 1940s. This section will also consider the issues of contingent fee agreements and champerty and how these compensation practices may facilitate the self interest of attorneys who initiate Section 16(b) suits. Lastly, this section will deal with the issues of solicitation and whether attorneys who find someone to purchase the security of the "issuer" (such as friends or family) for the sole purpose of initiating a law suit are acting ethically.

Section VII discusses possible solutions to the problems associated with Section 16(b) actions, including other alternatives to the problems associated with instituting a Section 16(b) suit. One such solution may be to amend Section 16(b) to permit, as plaintiffs, only those who are shareholders at the time of the alleged trade. In the alternative, the *United States v. O'Hagan* decision,<sup>15</sup> may offer a solution, thereby determining that there may no longer be a need for Section 16(b). It concludes with a focus on a contemporary view of the intent and purpose of Section 16(b), and discusses what measures could be taken to cure the ongoing problems associated with this Section.

## I. THE FACTUAL SETTING

Imagine two different hypotheticals which might occur in today's stock markets. In the first, a corporate officer in a publicly traded corporation obtains confidential, non-disclosed material information regarding an upcoming merger of his business. He decides that this would be the perfect opportunity to make a sizable profit by purchasing stock in his company, the price of which he knows is likely to soar when news of the proposed merger is disclosed publicly.<sup>16</sup> The officer

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<sup>14</sup> 501 U.S. 115 (1991), *aff'g* 909 F.2d 724 (2d Cir. 1990).

<sup>15</sup> 521 U.S. 642 (1997).

<sup>16</sup> NEW YORK STOCK EXCHANGE LISTED COMPANY MANUAL §§ 202.05 202.06 (The Exchange 1992).

202.05 Timely Disclosure of Material News Developments

A listed company is expected to release quickly to the public any news or

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information which it might reasonably be expected to materially affect the market for its securities. This is one of the most important and fundamental purposes of the listing agreement which the company enters into with the Exchange.

A listed company should also act promptly to dispel unfounded rumors which result in unusual market activity or price variations.

#### 202.06 Procedure for Public Release of Information

##### (A) Immediate Release Policy

The normal method of publication of important corporate data is by means of a press release. This may be either by telephone or in written form. Any release of information that could reasonably be expected to have an impact on the market for a company's securities should be given to the wire services and the press *For Immediate Release*. . . .

##### (B) Telephone Alert to the Exchange

When the announcement of news of a material event or a statement dealing with a rumor which calls for immediate release is made shortly before the opening or during market hours (presently 9:30 A.M. to 5:00 P.M., New York time), it is recommended that the company's Exchange representative be notified by telephone at least ten minutes prior to release of the announcement to the news media. If the Exchange receives such notification in time, it will be in a position to consider whether, in the opinion of the Exchange, trading in the security should be temporarily halted. A delay in trading after the appearance of the news on the Dow Jones or Reuters news wires provides a period of calm for public evaluation of the announcement. . . . A longer delay in trading may be necessary if there is an unusual influx of orders. The Exchange attempts to keep such interruptions in the continuous auction market to a minimum. However, where events transpire during market hours, the overall importance of fairness to all those participating in the market demands that these procedures be followed.

##### (C) Release to Newspapers and News Wire Services

News which ought to be the subject of immediate publicity must be released by the fastest available means. The fastest available means may vary in individual cases and according to the time of day. Ordinarily, this requires a release to the public press by telephone, telegraph, or hand delivery, or some combination of such methods. Transmittal of such a release to the press solely by mail is not considered satisfactory. Similarly, release of such news exclusively to the local press outside of New York City would not be sufficient for adequate and prompt disclosure to the investing public.

To insure adequate coverage, releases requiring immediate publicity should be given to Dow Jones & Company, Inc., and to Reuters Economic Services.

Companies are also encouraged to promptly distribute their releases to Associated Press and United Press International as well as to newspapers in New York City and in cities where the company is headquartered or has plants or other major facilities. . . .

*Id.* (emphasis added).

In 1970, the SEC issued a general release relating to the disclosure of material corporate developments. See SEC comment on Timely Disclosure of Material Corporate Developments, Securities Act Release No. 5092, Exchange Act Release No. 8995, Fed. Sec.

purchases the stock. A few weeks later, an appropriate formal announcement about the upcoming merger is made. As anticipated by the officer, the corporation's stock price doubles quickly. The officer then sells his newly acquired stock for a multi-million dollar profit.

In the second hypothetical, a corporate officer, also in a publicly traded corporation, buys 1000 shares of stock in her company to help fund her child's education. She purchases that stock for \$100.00 per share. Five months later, she is compelled to sell these shares to meet a medical emergency for the child. Fortunately, during those five months, the price per share for the corporation's stock has increased from \$100.00 to \$175.00 per share. While the officer possessed knowledge of material, non-public information, she did not base her decision to purchase or sell on that news.

When comparing these situations, it seems appropriate that the officer in the first example should be subject to discipline because he was engaging in insider trading, using material, inside information for his own personal gain.<sup>17</sup> In the second example, the officer was the beneficiary of a strong market, but never used her position in the corporation to aid her in personally gaining from the sale of the stock. Equitably, it does not seem appropriate to punish the latter just because she had some good fortune. Unfortunately for both parties, Section 16(b) holds them both liable for all "profits" realized in the transactions. In fact, as is discussed later, the defendant in the latter case can be found liable for much more monetary damages than her actual taxable profits, unlike defendants with criminal intent in Section 10(b) cases.<sup>18</sup>

## II. THE POLITICAL SETTING

In 1934, Congress enacted the Securities Exchange Act of 1934,<sup>19</sup> to deal with issues relating to the sale and purchase of securities. Section 10(b) of that Act

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L. Rep. (CCH) ¶ 77,915, at 80,035 (Oct. 15, 1970). See also THOMAS LEE HAZEN, *THE LAW OF SECURITIES REGULATION* 1 (3d ed., 1996) (citing ROBERT SOBEL, *N.Y.S.E.: A HISTORY OF THE NEW YORK STOCK EXCHANGE 1935-1975* (1975) and Dennis S. Karjala, *Federalism, Full Disclosure and the National Markets in the Interpretation of Federal Securities Law*, 80 *Nw. U. L. REV.* 1473 (1986)).

<sup>17</sup> See e.g., *S.E.C. v. Texas Gulf Sulphur Co.*, 401 F.2d 833 (2d Cir. 1968) (en banc), cert. denied, 394 U.S. 976 (1969). The officer also has Williams Act and mail fraud liability as well. See e.g., *Rondeau v. Mosinee Paper Corp.*, 422 U.S. 49 (1975); *Piper v. Chris-Craft Indus., Inc.*, 430 U.S. 1 (1977); *United States v. O'Hagan*, 521 U.S. 642 (1997).

<sup>18</sup> See 15 U.S.C. § 78j (1994).

<sup>19</sup> Securities Exchange Act of 1934, 15 U.S.C. §§ 78a-78mm (West 1997).

provided, quite simply:

[It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange . . . (b) to use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

However, with no definition of terms or official guidelines as to its use, § 10(b) was little used for a decade. Then Milton Freeman, who created it, speaking in 1967 at a conference on the codification of the Federal Securities Laws with Sumner Pike and the recently deceased Louis Loss on the panel, said:

I think it would be appropriate for me now to make a brief statement of what actually happened when 10b-5 was adopted, where it would be written down and be available to everybody, not just the people who are willing to listen to me.

It was one day in the year 1943, I believe. I was sitting in my office in the S.E.C. building in Philadelphia and I received a call from Jim Treanor who was then the Director of the Trading and Exchange Division. He said, "I have just been on the telephone with Paul Rowen," who was then the S.E.C. Regional Administrator in Boston, "and he has told me about the president of some company in Boston who is going around buying up the stock of his company from his own shareholders at \$4.00 a share, and he has been telling them that the company is doing very badly, whereas, in fact, the earnings are going to be quadrupled and will be \$2.00 a share for the coming year. Is there anything we can do about it?" So he came upstairs and I called in my secretary and I looked at Section 10(b) and I looked at Section 17, and I put them together, and the only discussion we had there was where "in connection with the purchase or sale" should be, and we decided it should be at the end.

We called the Commission and we got on the calendar, and I don't remember whether we got there that morning or after lunch. We passed a piece of paper around to all the commissioners. All the commissioners read the rule and they tossed it on the table, indicating approval. Nobody said anything except Sumner Pike

who said, "Well," he said, "we are against fraud, aren't we?" That is how it happened.

Louis is absolutely right that I never thought that twenty-odd years later it would be the biggest thing that had ever happened. It was intended to give the Commission power to deal with this problem. It had no relation in the Commission's contemplation to private proceedings. Milton Freeman, *Administrative Procedures*, 22 *Bus. Law* 793, 922 (1967).

Contrariwise, Section § 16(b) was specifically written as a strict liability statute intended "to prevent the abuse of the use of inside information by officers, directors, and more than 10% shareholders."<sup>20</sup> The legislature history of this section reveals that Congress intended it to be the main provision to stop insider trading.<sup>21</sup>

Just one year after the adoption of the Securities Act of 1933,<sup>22</sup> which regulated the initial issuance of securities, Congress became alarmed by certain types of stock trading by officers and directors of public corporations.<sup>23</sup> It concluded that there was a need to restore the integrity of the stock market in order to encourage participation by the general public.<sup>24</sup> Ordinary people who bought and

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<sup>20</sup> In *Freedman v. Barrow*, a federal court stated that by enacting the "short swing" profits provision of this section, Congress recognized that short swing speculation by large stockholders, officer and directors, all of whom might have access to inside information, would threaten the goal of section 16(b) "to insure the maintenance of fair and honest markets," 427 F. Supp. 1129, 1148 (S.D.N.Y. 1976). In *Wagman v. Astle*, the federal court stated that the purpose of Section 16(b) was to restore eroded investor confidence in the integrity of the stock market. 380 F. Supp. 497, 501 (S.D.N.Y. 1974). The Court expressed the rationale that "it is unfair for some to profit in ways that others cannot." *Id.*

<sup>21</sup> See *Wagman*, 380 F. Supp. at 501.

<sup>22</sup> Securities Act of 1933, 15 U.S.C. §§ 77a-77bbbb (1994).

<sup>23</sup> See Susan A. Wetzel, Comment, *New Rule 16b-3, the SEC's Attempt to Aid Insiders by Revising Rule 16b is Much Ado About Nothing*, 24 *OHIO N.U. L. REV.* 125, 128 (1998).

<sup>24</sup> *Smolowe v. Delendo Corporation*, stated that the policy behind the creation of Securities Exchange Act was to "insure a fair and honest market, that is, one which would reflect an evaluation of securities in light of all available and pertinent data." 136 F.2d 231, 235 (2d Cir. 1943). The court reviewed the background of the section and determined that "speculation by insiders, officers, directors and principal shareholders was a widely condemned evil," according to the Hearings before Committee on Banking and Currency. *Id.* See also Hearings before Committee on Banking and Currency on S. 84, 72d Cong., 2d Sess., and S. 56 and S. 97, 73d Cong., 1st and 2d Sess., 1934. The court concluded that the only solution which the framers deemed effective for this action was "the imposition of liability based upon an objective measure of proof." *Smolowe*, 136 F.2d at 235.



sold shares were being disadvantaged by the fact that "insiders"<sup>25</sup> were in a position to find out valuable information concerning their own company's stock before it was known to the public and use this information to make a profit. Having defined such public policy, Congress took the step of imposing strict liability upon those officers, directors and ten percent shareholders who transacted certain "short" sales of the issuer's securities.<sup>26</sup> The end result Congress desired was the elimination of the unfair practice known as "insider trading."<sup>27</sup>

### III. AN OVERVIEW OF THE ISSUES

While the intent of Congress was the restoration in the faith and integrity of the stock market, the following issues soon arose in conjunction with the new Section 16(b). Many of these stemmed from the language used in the section and others from the interpretations which courts made when defining it.<sup>28</sup>

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The court cited Mr. Corcoran's testimony, a chief spokesman for the draftsmen and proponents of the Act, wherein he stated, "You hold the director, irrespective of any intention or expectation to sell the security within six months after, because it will be absolutely impossible to prove the existence of such intention or expectation, and you have to have this crude rule of thumb, because you cannot undertake the burden of having to prove that the director intended, at the time he bought, to get out on a short swing." *Id.* The court confirmed its position by noting that had Congress intended that only profits made by the misuse of inside information would be recoverable, it would have said so. *Id.* at 236. Therefore, because Congress did not limit the recovery to profits gained by the misuse of information, neither would the Court. *See Id.* at 237.

<sup>25</sup> Initially defined as officers, directors, and those owning over 10 per centum of a corporation's stock. 15 U.S.C. §78p(a) (1994).

<sup>26</sup> *See* Ellen Taylor, *Teaching an Old Law New Tricks: Rethinking Section 16*, 39 ARIZ. L. REV. 1315, 1319 (1997).

<sup>27</sup> Wetzel, *supra* note 23, at 127 & n.14, noting that a 1915 *New York Times* survey showed that 90% of business executives interviewed admitted to trading regularly in their own corporation shares. *See also* HENRY G. MANNE, *INSIDER TRADING AND THE STOCK MARKET* 2 (1966). However, there is some contrary belief as to the actual intention of Section 16(b). *See generally* Karl Shumpei Okamoto, *Rereading Section 16(b) of the Securities Exchange Act*, 27 GA. L. REV. 183 (1992) (proposing that Section 16(b) was actually intended to prevent market manipulation, because insiders have the ability to artificially move stock prices by trading on their privileged information); Steve Thel, *The Genius of Section 16: Regulating the Management of Publicly Held Companies*, 42 HASTINGS L.J. 391 (1991) (stating that the Act's purpose was to discourage manipulation of corporate affairs to create opportunities to trade corporate stock profitably, since insiders generally invest for the long term).

<sup>28</sup> Section 16 has two primary subsections which set out its requirements and 3 additional ones which limit the Section's overall scope. Section 16(a) places requirements on certain

Section 16(b) entitles the issuer, or a security holder bringing suit on the issuer's behalf, to recover short swing profits realized from the purchase and sale by a subject insider of such issuer's equity securities within a six-month period.<sup>29</sup> Basically, it prohibits insiders from making a profit on transactions in their company's securities when the purchase and sale of the securities both occurred within a six-month period. Section 16(b) is controlled by an irrefutable presumption that the profits gained by the insider were produced unfairly. Therefore, insiders must disgorge any profits realized in this type of short swing transaction and return the profit to the company. This disgorgement controls irrespective of the purchasers actual intent.<sup>30</sup>

Section 16(c) prevents insiders from profiting from downturns in the price of their corporation's securities by prohibiting short sales "against the box." In a short sale, the seller does not actually own the stock. Instead, the seller borrows stock, generally from his or her broker, and sells it in the market. The seller must at some later time replace the borrowed securities by purchasing replacement securities in the market. The seller engages in short selling in the hope that the market price will decline because the replacement securities may be purchased at a lower price than those initially sold (the borrowed securities), thus creating a profit. Section 16(d) and Section 16(e) exempt certain transactions from the overall coverage of Section 16.<sup>31</sup>

### A. *Standing*

One particular issue was the fact that a person suing to disgorge a "short

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statutorily defined insiders to report to the SEC their beneficial stock interests. Section 16(a) defines those insiders which are subject to the requirements as "every person who is directly or indirectly the beneficial owner of more than 10 per centum of any class of an equity security (other than an exempted security) which is registered pursuant to section 78(1) of this title (section 12 of the Securities and Exchange Act of 1934), or who is a director or an officer of the issuer of such security." Pursuant to Section 16(a), these defined insiders must file an initial report when their company's securities are registered under Section 12 or within 10 days after becoming statutory insiders. Following the initial report, insiders must file transaction reports by the tenth day of the month following any month in which there has been a substantial change in their ownership, and they must also file annual statements of beneficial ownership with the SEC. *See generally*, Securities Exchange Act of 1934 § 16, 15 U.S.C. § 78 (1994).

<sup>29</sup> 15 U.S.C. §78p(b) (1994).

<sup>30</sup> *See id.*

<sup>31</sup> *Id.* §§ 78p(d), 78p(e).

swing" transaction did not have to be a shareholder at the time that the alleged illegal transaction took place.<sup>32</sup> The only step the plaintiff had to take in order to obtain standing was to be an "owner of [a] security" of the "issuer" when he filed the complaint.<sup>33</sup> He did not even have to be a shareholder at the time of the trade.<sup>34</sup>

Section 16(b) thus still makes it easy for a party to bring an action against an insider who has violated Section 16(b) for five distinct reasons. Specifically, Section 16(b) provides that a plaintiff in a Section 16(b) suit must be the owner of a "security" of the issue corporation.<sup>35</sup> A "security" for purposes of Section 16(b) includes warrants, convertible debentures, bonds, puts, calls, and a variety of other financial instruments.<sup>36</sup> This expansive determination of what a "security" entails for purposes of Section 16(b) increases the chances of a party having a means to achieve standing to bring a suit against an insider.

Second, the plaintiff can be either the "record" or "beneficial" owner of a subject security.<sup>37</sup> This point confers standing on a wide array of potential plaintiffs. Then, the plaintiff need only own the security at the time he institutes the suit against the insider, not at the time of the purchase and sale by the insider.<sup>38</sup>

Moreover, there are no restrictions in terms of either the number or percentage of shares or the value of such securities that must be held by the plaintiff.<sup>39</sup> This plaintiff could purchase one share of stock, allege that there is a Section 16(b) violation, and properly bring a suit. Finally, case law makes it even easier by granting attorneys' fees to attorneys who represent successful plaintiffs,

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<sup>32</sup> See *id.* § 78p(b).

<sup>33</sup> *Id.* See generally Marc I. Steinberg & Daryl L. Landsdale, Jr., *The Judicial and Regulatory Construction of Section 16(b) of the Securities Exchange Act of 1934*, 68 NOTRE DAME L. REV. 33, 38-55 (1992).

<sup>34</sup> See 15 U.S.C. § 78 p(b) (1994).

<sup>35</sup> *Id.*

<sup>36</sup> See generally *S.E.C. v. W.J. Howey Co.*, 328 U.S. 293 (1946); see also Securities Act of 1933, 15 U.S.C. §§ 77a-77bbbb (1994).

<sup>37</sup> See generally *Chemical Fund, Inc. v. Xerox Corp.*, 377 F.2d 107 (2d Cir. 1967). See also 15 U.S.C. § 78m(d) (1994). See also THOMAS LEE HAZEN, *THE LAW OF SECURITIES REGULATION* 709 (3d ed., 1996) (stating that "nowhere in Exchange Act is the concept of beneficial ownership explicitly defined and therefore its scope has been limited to judicial interpretation and administrative rulemaking.").

<sup>38</sup> See *Dottenheim v. Murchison*, 227 F.2d 737, 740 (5th Cir. 1955), *cert. denied*, 351 U.S. 919, (1957); see also *Blau v. Mission Corp.*, 212 F.2d 77, 79 (2d Cir. 1954), *cert. denied*, 347 U.S. 1016 (1954).

<sup>39</sup> *Gollust v. Mendell*, 501 U.S. 115, 123 (1991).

thus eliminating the cost of litigation for the plaintiff.<sup>40</sup>

### B. Champerty and its Residue

Other key issues concerning this statute are the use of contingent fees, champerty and solicitation. A contingent fee is "a charge made by an attorney dependent upon a successful outcome in the case and is often agreed to be a percentage of the party's recovery."<sup>41</sup> Champerty is an agreement between an attorney and his client in which the attorney is essentially the real party in interest in the client's suit and pays the costs in return for a large portion of the damages awarded.<sup>42</sup> Startlingly, although champerty is a violation of the Model Rules of Professional Responsibility,<sup>43</sup> and state law,<sup>44</sup> a defense of champerty in a Section 16(b) cause of action is not permitted.<sup>45</sup>

In a related sense, there also is an issue of solicitation in Section 16(b) lawsuits. Attorneys who understand the lenient standing requirements may be inclined to solicit potential clients or, in the alternative, "create" clients to sue for a Section 16(b) violation.<sup>46</sup> Although solicitation in some respects has been upheld

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<sup>40</sup> See *Gilson v. Chock Full O'Nuts Corp.*, 326 F.2d 246, 248 (2d Cir. 1964), *aff'd on reh'g en banc*, 331 F.2d 107 (2d Cir. 1964).

<sup>41</sup> BARRON'S LAW DICTIONARY 38 (4th ed. 1996). *Wells v. Sullivan*, 907 F.2d 367, 369 (2d Cir. 1990) ("absent fraud or overreaching, courts must enforce such private contingency fee agreements, which are, after all, embodiments of the intentions and wishes of the parties. . .").

<sup>42</sup> See generally, 9 LOUIS LOSS & JOEL SELIGMAN, SECURITIES REGULATIONS 4286-89 (3d ed. 1992).

<sup>43</sup> MODEL RULES OF PROFESSIONAL CONDUCT Rule 1.8(j) (1998). Contingent fees are an exception to Rule 1.8(j). *Id.* Rule 1.8(j)(2). See generally Rule 1.5(c).

<sup>44</sup> THOMAS LEE HAZEN, THE LAW OF SECURITIES REGULATION 391 & 19, 389 & 3 (3d ed. 1996) (citing CAL. CORP. CODE §§ 25000-25804 (West 1999)). "Most statutes are based in whole or part upon the American Law Institute's Uniform Securities Act. UNIF. SECURITIES ACT, 7B U.L.A. 509-687 (1985 and Supp. 1988).

<sup>45</sup> See *Magida v. Continental Can Co.*, 231 F.2d 843, 848 (2d Cir. 1956).

<sup>46</sup> Indeed, the plaintiff "shareholder" in several § 16(b) suits was the owner of the newstand in the plaintiff's attorney's building lobby. One district court held "unbelievable (his) own testimony that he had cash funds adequate to pay (fees)" noting the lack of any bank accounts or sign of wealth . . . ." *Blau v. Lamb*, 314 F.2d 618, 619 (2d Cir. 1963), *cert. denied*, 375 U.S. 813 (1963). See also *Ohralik v. Ohio State Bar Ass'n*, 436 U.S. 447 (1978) (holding that "in-person solicitation for pecuniary gain" does not warrant First Amendment protection as does advertising in the *Bates* case, *infra* note 48); see also, *Zauderer v. Office of Disciplinary Counsel of the Sup. Ct. of Ohio*, 471 U.S. 626 (1985)

by the Courts, such as in an advertising context,<sup>47</sup> a question arises whether it is appropriate in the context of Section 16(b).

Since Section 16(a) requires that an insider report any trades involving his company's stock to the Securities and Exchange Commission, it is a simple project for a clerk to comb through these publicly accessible reports in order to find a "violation." Then the attorney can solicit "a plaintiff," so that, in essence, the attorney enforces Section 16(b) and receives sizable fees for his work. The corporation actually pays this fee since it, in theory, has received a "benefit" from attorney, i.e., the legal services that resulted in the recovery from the insider who had no culpable intention. Of course, the net profits of the corporation and the shareholders book value, are reduced by these fees.

Cases have held that the attorney is entitled to a "reasonable" fee for the services rendered.<sup>48</sup> The question is - is that fee justified for the amount of the work done?

In a typical scenario, the attorney finds both a violation and a plaintiff, and then writes a demand to the company for the enforcement of Section 16(b). If the insider returns the profit to the company without further legal action, the attorney still is entitled to a substantial percentage of the recovery. The plaintiff receives a minuscule amount in relation to the attorney fees awarded. In one case, the individual plaintiff received only \$1.10, and the bulk of the award went to pay attorneys fees.<sup>49</sup>

This creates a "misincentive" for the attorney. Obviously there are minor costs to search through Securities and Exchange Commission records and find a violation, which should be compensated if there is a recovery for the plaintiff and the corporation, but should it not be reasonable?

This scenario also perpetuates the public's hostile view of attorneys.

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(holding that a lawyer is free to place a newspaper advertisement intended for luring a specific group of people as her clients).

<sup>47</sup> *Bates v. State Bar of Ariz.*, 433 U.S. 350 (1977) (holding that there can be no restriction on truthful advertising and this restriction would be a violation of the First Amendment).

<sup>48</sup> See generally MODEL RULES OF PROFESSIONAL CONDUCT Rule 1.5(a) (1998) (for determining "reasonableness"); see also *Robert L. Wheeler, Inc. v. Scott*, 777 P.2d 394, 395-96 (Okla. 1989) (basing an analysis of the "reasonableness" of attorney fees on twelve discussed factors).

<sup>49</sup> *Magida v. Continental Can Co.*, 231 F.2d 843, 847 (2d Cir. 1956).

Attorneys appear to have an excessive incentive to litigate merely for the fees involved; not to right a true "wrong" or help a truly aggrieved plaintiff recover a loss to which he may be entitled. The public perception of lawyers is already extremely negative and surveys have shown a consistent dissatisfaction with the legal profession as a whole.<sup>50</sup> This Section 16(b) situation hurts the image of attorneys and the legal profession in general. It is doubtful that this result was envisioned by the drafters of the Securities Exchange Act of 1934.

### C. Elements of the Lawsuit

Since the 1930's, the federal government has developed a framework of criminal and civil laws designed to prevent corporate insiders from profiting in the securities markets on the basis of nonpublic material information.<sup>51</sup> Cases involving Section 16(b) have generally focused on the definition of "sale" or "purchase,"<sup>52</sup> the definition of a "security,"<sup>53</sup> and what roles in a corporation are considered "insider positions."<sup>54</sup> Regrettably, there have been only a few cases on the identity of the plaintiff or the appropriateness of the fees awarded to the attorneys.<sup>55</sup>

An initial reading of Section 16(b) leads a reader to believe that Section 16(b) should be an effective tool to deter insiders from trading on non-public information. The most striking benefit is the fact that Section 16(b) does not require any proof as to the intent of the purchaser/seller in successfully finding a violation under Section 16(b). In other words, it is a strict liability statute.<sup>56</sup> The only proof that the rule requires for a successful prosecution is that the insider

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<sup>50</sup> See Barbara Rosen, *Simple Things You Can Do Everyday to Improve Your Image*, PA. LAW, Jan. 1994, at 22.

<sup>51</sup> 15 U.S.C. § 78p(b) (1994).

<sup>52</sup> See Taylor, *supra* note 26, at 1323-24. The process of starting a suit has a shareholder of the issuer asking the issuer to require the insider to disgorge the profits. *Id.* at 1324. If the issuer fails to do so within 60 days, then the shareholder may file a suite to compel disgorgement. *Id.* at 1324-25.

<sup>53</sup> See generally *Gollust v. Mendell*, 501 U.S. 115 (1991).

<sup>54</sup> See generally *Steinberg & Landsdale*, *supra* note 33, at 38, 69-78.

<sup>55</sup> See e.g., *Blau v. Mission Corp.*, 212 F.2d 77 (2d Cir. 1954), *cert. denied*, 347 U.S. 1016 (1954); *Blau v. Oppenheim*, 250 F.Supp. 881 (S.D.N.Y. 1966). See generally John C. Coffee, Jr., *Understanding the Plaintiff's Attorney: The Implications of Economic Theory for Private Enforcement of Law Through Class and Derivative Actions*, 86 COLUM. L. REV. 669 (1986). See also *Blau v. Rayette-Faberge, Inc.*, 389 F.2d 469, 472 (2d Cir. 1968), (citing *Smolowe v. Delendo Corp.*, 136 F.2d 231 (2d Cir. 1943)).

<sup>56</sup> *Wetzel*, *supra* note 23, at 133.

bought and sold corporate securities within a six-month ("short swing") period.<sup>57</sup> Therefore, if an insider trades within the six-month period he is liable no matter what his excuse for making the trades.

*D. Let's Stop Calling Them "Profits"*

"Profit" calculations for insider trading are formulated so as to insure that the highest amount of money will be disgorged from the insider. For purposes of finding a violation under Section 16(b), it is irrelevant whether the purchase precedes the sale or vice versa.<sup>58</sup> As the Second Circuit stated, "the only rule whereby all possible profits can surely be recovered is that of lower price in, highest price out within six months."<sup>59</sup>

However, no such definition of "profit" can be found in any other accounting or economic theory. In essence, the statute allows recovery of much more than the real, taxable gains made by the defendant. This is a severely punitive result especially when the defendant had no scienter or criminal culpability. Contrariwise, a defendant with criminal intent in a Rule 10b-5 case can be fined and "profits" are calculated in a traditional accounting context.

To facilitate this maximum "profit" calculation, Section 16(b) does not even combine all of the transactions within a six-month period to determine whether an insider has a cumulative profit.<sup>60</sup> Instead, it matches the absolute lowest purchase prices with the actual highest sales prices to calculate the moneys to be repaid. As a result, an insider<sup>61</sup> could actually have a cumulative loss during a given six-month trading period and still be required to pay "profits" back to the corporation. The following example illustrates this point.

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<sup>57</sup> *Id.*

<sup>58</sup> See 15 U.S.C. §78p(b) (1994).

<sup>59</sup> *Smolowe*, 136 F.2d at 239; see also *Gratz v. Claughton*, 187 F.2d 46, 52 (2d Cir. 1951).

<sup>60</sup> *Taylor*, *supra* note 26, at 1317.

<sup>61</sup> The effectiveness of Section 16(b) regarding a 10% beneficial owner is not as concrete as the other statutory insiders. A beneficial owner may be liable under Section 16(b) only if he owned more than 10% of the stock at the time of the purchase *and* at the time of the sale. *Reliance Elec. Co. v. Emerson Elec. Co.*, 404 U.S. 418, 419 (1972).

Assume that an insider enters into the following transactions:

- |  |   |
|--|---|
| 1) Buys 100 shares on 1/2/00 @ \$100/share   | 5) Sells 100 shares on 3/3/00 @ \$105/share |
| 2) Buys 100 shares on 1/12/00 @ \$70/share   | 6) Buys 100 shares on 4/1/00 @ \$110/share  |
| 3) Sells 100 shares on 1/21/00 @ \$120/share | 7) Buys 100 shares on 4/3/00 @ \$90/share   |
| 4) Sells 100 shares on 3/2/00 @ \$75/share   | 8) Sells 100 shares on 5/2/00 @ \$150/share |

When calculating the punitive damages owed in the above transactions, the purchases and sales which produce the highest spread are put together, notwithstanding whether the sale preceded the purchase or the purchase preceded the sale. Therefore, the "profit" calculations of the insider's transactions are as follows:

<u>Purchases</u>	<u>Sales</u>	<u>Profit</u>
100 @ \$ 70 (#2)	100 @ \$150 (#8)	\$8,000
100 @ \$ 90 (#7)	100 @ \$120 (#3)	\$3,000
100 @ \$100 (#1)	100 @ \$105 (#5)	\$ 500
100 @ \$110 (#6)	100 @ \$ 75 (#4)	\$ 0

Under this scenario, the statutory "profit" made by the insider during these transactions is \$11,500, whereas his actual, taxable and accounting profit would be \$8,000. This larger amount is what the insider is required to repay under Section 16(b). This is a system which no longer needs to exist when Section 10(b) allows a comprehensive look at culpability. The *Smolowe* and *Gratz* cases were decided before Rule 10b-5 litigation developed. The facts in these cases should turn on intent - not strict liability.

#### *E. The Appropriate Role of § 16(a)*

Section 16(a)<sup>62</sup> provides for a thorough system to facilitate disclosures of

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<sup>62</sup> 15 U.S.C. § 78p(a) (1994).



information regarding insider holdings and trades.<sup>63</sup> This information produces insight for the market as a whole and the regulatory authorities as to appropriate conduct by insiders. Corporations and their counsel have developed extensive training and counseling systems to admonish affected persons of the illegality of insider trades and proper techniques under which such trades may be made.<sup>64</sup> Attendant publicity about those prosecuted for such violations as well as a vigorous SEC enforcement division using Rule 10(b)<sup>565</sup> give society adequate protection against these evils.

#### *F. Omitted Defendants*

Section 16(b) is underinclusive in that it does not include all employees who may have valuable inside information and trade.<sup>66</sup> A non-officer employee or outside consultant to a corporation who makes a large, real accounting profit within a six-month statutory period will not be required to disgorge profits under Section 16(b).

Section 16(b) also is underinclusive with regard to the type of securities that are applicable to Section 16(b). Section 16(b) only applies to insiders of corporations whose equity securities are registered under Section 12 of the Securities Exchange Act of 1934.<sup>67</sup> The requirements of Section 12 mean that those are large publicly held corporations. However, many companies are not registered or not required to register under Section 12.<sup>68</sup> Section 16(b) has no application to these corporations and has no ability to discourage officers of these entities from engaging in insider trading, a material weakness of the statute. In short, the same conduct by the CEOs of two major corporations is treated differently.

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<sup>63</sup> Section 16(a) provides that a person who is the beneficial owner of more than 10 per centum of any class of equity security, or who is an officer or director of the issuer of the security, must file a registration statement with the Commission within ten days after they become a beneficial owner, officer, or director. 15 U.S.C. § 78p(a) (1994).

<sup>64</sup> Such cautionary memoranda also are required by the Insider Trading Sanctions Act of 1984, Pub. L. No. 98-376, 99 Stat. 1264.

<sup>65</sup> 17 C.F.R. § 240.106-5 (1997).

<sup>66</sup> Taylor, *supra* note 26, at 1323.

<sup>67</sup> Section 12(b) requires registration when a security becomes listed on a national securities exchange. Securities Exchange Act of 1934 §12(b), 15 U.S.C. § 78l(a) (1994). Section 12(g) requires registration when the issuer has more than \$1,000,000 in assets and at least 500 shareholders. 15 U.S.C. § 78l(g)(1) (1994). *But see* 17 C.F.R. § 240.12g-1 (1997) (modifying Section 12(g)(1) to exempt from the registration requirement any issuer with assets not exceeding \$10,000,000).

<sup>68</sup> Taylor, *supra* note 26, at 1323.

Another problem is the statutorily defined transaction period. Section 16(b) only applies to sales and purchases which both occur within a six-month period.<sup>69</sup> Congress apparently believed that the six-month period would capture virtually all transactions in which there might be an opportunity to profit from the use of inside information.<sup>70</sup> However, despite Congress' belief, the application of Section 16(b)'s statutory transaction period produces an overinclusive effect. Since the period does not inquire into whether a trader, in fact, used inside information, but instead sets an arbitrary time period during which profits are prohibited,<sup>71</sup> traders are prosecuted even if they do not trade on inside information, so long as they traded within the six-month period.

Furthermore, Congress' reasons for creating the six-month period do not seem to be relevant in today's markets. In 1934, six months was an adequate time period with which to make sure that the inside information became known to the general public. Today's extraordinary era of instantaneous mass communication calls for a considerably shorter time period. Furthermore, there is a large corps of market analysts who are vigilant in their search for information about the companies which they follow. These developments, together with SEC rules requiring companies to provide more forward looking information,<sup>72</sup> make it substantially more difficult to keep information secret for extended periods of time. The statutorily defined period is too long as it stands, and as such, poses a problem in its application.

### G. Omitted Plaintiffs

The Securities and Exchange Commission has no authority to enforce § 16(b) as it does with other provisions of the Securities Exchange Act.<sup>73</sup> By only allowing the corporation or individual shareholder plaintiff to sue, Congress created enforcement through "private attorneys general."<sup>74</sup> Now that § 10(b) and its Rule

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<sup>69</sup> 15 U.S.C. §78p(b) (1994).

<sup>70</sup> Taylor, *supra* note 26, at 1324 & n.35. (citing to the Committee on Federal Regulation of Securities, *Report of the Task Force on Regulation of Insider Trading, Part II: Reform of Section 16*, 42 BUS. LAW. 1087, 1130 (1987)).

<sup>71</sup> *Id.* at 1323. *See also* 15 U.S.C. § 78p(b) (1994).

<sup>72</sup> Private Securities Litigation Reform Act of 1995, Pub. L. No. 104-67, 109 Stat. 737 (codified at 15 U.S.C.A. § 78 u-4 (West 1997)) and the Securities Litigation Uniform Standards Act of 1998, Pub. L. Co. 105-353, 112 Stat. 3227 (codified at 15 U.S.C.A. §§ 77p, 77bb (West 1997 and Supp. 1999)).

<sup>73</sup> *See* 15 U.S.C. § 78p(b) (1994).

<sup>74</sup> Coffee, *supra* note 55, at 669.

10(b)5 have been interpreted so broadly, it is time to place the burden where it belongs: on the SEC.

Section 16(b) also is unlike other statutes in that the contemporaneous ownership requirement of Fed. R. Civ. P. 23.1 does not apply.<sup>75</sup> Fed. R. Civ. P. 23.1 states that, in a derivative action brought by one or more shareholders to enforce the right of a corporation which has failed to enforce the right, the complaint must be verified and allege "(1) that the plaintiff was a shareholder or a member at the time of the transaction of which the plaintiff complains."<sup>76</sup> In a Section 16(b) action all that is required is that the shareholder be an owner of the security at the time he initiates the suit and maintain that status throughout the pendency of the lawsuit.<sup>77</sup>

In reality, there are situations in which the corporation changes its identity. For instance, in a case in which the defendant corporation merged with another corporation during litigation, the question arose whether the plaintiff shareholder still had standing to sue for the short swing transactions done by those associated with the subsidiary.<sup>78</sup>

In that case, the Court interpreted the category of shareholders involved in initiating a Section 16(b) suit, as those who have a "financial stake" in the litigation. A stockholder of the issuer claimed that there were shares traded in violation of Section 16(b). However, that corporation was acquired by Viacom and the shareholder's stock in the issuer had been exchanged.<sup>79</sup>

The court held that the shareholder could maintain the suit even though the company's stock no longer existed since it was acquired by another corporation.<sup>80</sup> The Court discussed Congress' intent to put "a private-profit motive behind the uncovering of this kind of leakage of information, [by making] the stockholders

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<sup>75</sup> FED. R. CIV. P. 23.1. A complaint by the shareholder against the corporation shall allege that (1) plaintiff was a shareholder or member at the time of the transaction in question; and (2) the action is not a "collusive one to confer jurisdiction on a court of the United States which it would not otherwise have." *Id.* Additionally, complaint shall allege "with particularity" the reason(s) why the shareholder is taking action and reasons(s) why she represents the interest of "similarly situated" shareholders or members. *Id.*

<sup>76</sup> Fed. R. Civ. Pro Rule 23.1 (West Group 1997).

<sup>77</sup> *Portnoy v. Kawecky Berylco Indus., Inc.*, 607 F.2d 765, 767 (7th Cir. 1979).

<sup>78</sup> *Gollust v. Mendell*, 501 U.S. 115, 120-21 (1991).

<sup>79</sup> *Id.* at 118-19.

<sup>80</sup> *Id.* at 129.

[its] policemen,<sup>81</sup> and quoted draftsman Thomas G. Corcoran, while testifying before the House committee, who stated that Congress could be confident that Section 16(b) would be enforced because the enactment of the statute would "[say] to all of the stockholders of the company, 'you can recover any of this profit for your own account, if you find out that any such transactions are going on.'"<sup>82</sup>

The intent behind the provision that not only the corporation may initiate a suit, but that a stockholder would be able to take action if the corporation fails to do so, stems from the premise that if an officer, director or more than ten percent shareholder chooses to violate Section 16(b), he must be aware that someone with a profit motive will try to find out and initiate a lawsuit.<sup>83</sup> It appears that Congress, by granting standing of this considerable magnitude, wanted to ensure that many possible plaintiffs would be able to initiate a suit if needed, in order to deter insider trading of this sort.

In *Gollust*,<sup>84</sup> the Court held that because the plaintiff received shares in the parent corporation, he still maintained a financial interest in the outcome even after the merger. The court concluded that any finding of wrongdoing by the insider would force them to turn in profits to the new corporation. Thus, the shareholder who now had an interest in the new corporation, would stand to profit, albeit indirectly.<sup>85</sup>

This decision may limit the broad standing requirement by excluding those who are security holders of an issuer involved in a cash-out merger.<sup>86</sup> After a cash-out merger the shareholder no longer has a financial interest in the outcome of the litigation, as required by the *Gollust* Court. Due to the fact that the shareholder could not profit from the recoupment of the money, he should be denied standing.<sup>87</sup>

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<sup>81</sup> *Id.* at 124-25; (citing Hearings on H.R. 7852 and H.R. 8720 before the House Committee on Interstate and Foreign Commerce, 73d Cong., 2d Sess., 136 (1934) (testimony of Thomas G. Corcoran)).

<sup>82</sup> *Id.* at 125 & n.7.

<sup>83</sup> *Gollust*, 501 U.S. at 125 & n.7.

<sup>84</sup> 501 U.S. 115 (1991), *aff'g*, 909 F.2d 724 (2d Cir. 1990).

<sup>85</sup> *See id.* at 112.

<sup>86</sup> *See Steinberg & Landsdale, supra* note 33, at 41.

<sup>87</sup> *See id.* at 42.

#### IV. BALANCING THE SCALES – ARE THERE STILL MEANINGFUL "BENEFITS" TO § 16(B)?

While it is the position of this paper that there are major problems associated with Section 16(b) and its enforcement, it seems also that the points initially thought of as benefits to preventing insider trading can also be considered problems. For example, while the concept that a shareholder's attorney can be awarded his fees under Section 16(b) sounds beneficial because it may help encourage a reluctant shareholder to bring a Section 16(b) suit against an insider, such fees steer the focus away from preventing real culpable insider trading, and promote unethical dealings between client and lawyer.

Second, while strict liability seems like a benefit if insiders are deterred from engaging in insider trading because of the ease with which they may be found to be in violation of Section 16(b), the Act only includes the statutorily defined insiders and on a higher level corporate leaders and applies even if the defendant did not trade on insider information.

#### V. THE CAMEL UNDER THE TENT: UNFORSEEN RESULTS OF SECTION 16(B)

##### A. *The Setting: How Fees are Set:*

There are several proper methods for attorneys to obtain fees for their legal services, the major ones being through a fee agreement or retainer or on a contingent fee basis. A retainer is the advancement of payment to an attorney for his legal services. Contingency fees are based on the premise that the client will pay the attorney a percentage of the recovery if the outcome is successful. Such an agreement includes the work done by the attorney, but does not usually cover the out-of-pocket cost of litigation, for example court costs and discovery expenses. The client remains ultimately liable for these expenses. The overlap with champerty, the practice where the attorney seeks to recover his fee for legal services and the expenses he incurred by advancing the cost of the law suit himself, are clear.

An attorney's fee may be contingent on the outcome of a matter for which his service is rendered, except in a matter for which a contingent fee is prohibited, such as criminal and domestic cases.<sup>88</sup> A contingent fee agreement must be in writing and state the method by which the fee is to be determined, including the

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<sup>88</sup> MODEL CODE OF PROFESSIONAL RESPONSIBILITY DR 2-106, EC 2-20 (1981); MODEL RULES OF PROFESSIONAL CONDUCT Rule 1.5 (d) (1998).

percentage that will be paid to the lawyer in the event of a settlement, trial or appeal. Other expenses are to be added from the recovery.<sup>89</sup> Contingent fee agreements are permitted in the civil context. However, the advancement of expenses is precluded in many jurisdictions.<sup>90</sup>

Under traditional rules, the company pays the plaintiff's attorney's fees when the attorney confers a benefit on it in the form of the recovery of profits from the insider.<sup>91</sup> It is considered a windfall for the corporation.<sup>92</sup> In one case, the corporation recovered nothing, but still had to pay the attorney's fees, even though no benefit was conferred upon it.<sup>93</sup>

There are generally two ways to calculate the attorney's fees. The first is the "lodestar method," which compensates the attorney at his or her hourly rate, based on the time expended on the action.<sup>94</sup> This method of compensation has the drawback of encouraging the attorney to work more leisurely, thus running up the fee. Also, if there are disputes regarding the hourly rate of billing, the court will essentially have to determine whether the rate is fair and whether the time spent on the matter is reasonable, which uses up already scarce judicial resources.<sup>95</sup> Another drawback is that if the attorney spends enough time to find the violation and a plaintiff merely sends a demand letter prompting the insider to pay the profits without further action by the attorney, his hourly rate may not compensate for his time and effort. (The time the attorney spends searching for a security law violation is not attributable to the company that receives the benefit.)<sup>96</sup> This takes away the incentive for the attorney to monitor Section 16(b) violations, which is not what Congress had in mind when it wrote Section 16(b).<sup>97</sup> However, this method may be more fair to the corporation, especially if the amount of legal work is not

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<sup>89</sup> MODEL RULES OF PROFESSIONAL CONDUCT Rule 1.5 (c) (1998).

<sup>90</sup> See Theresa A. Gabaldon, *Free Riders and the Greedy Gadfly: Examining Aspects of Shareholder Litigation as an Exercise in Integrating Ethical Regulation and Laws of General Applicability*, 73 MINN. L. REV. 425, 443 (1988).

<sup>91</sup> See *Shlensky v. Dorsey*, 574 F.2d 131, 149 (3d Cir. 1978).

<sup>92</sup> See *Smolowe v. Delendo Corp.*, 136 F.2d 231, 241 (2d Cir. 1943).

<sup>93</sup> See *id.* See also *Gilson v. Chock Full O'Nuts Corp.*, 326 F.2d 246, 248 (2d Cir. 1964).

<sup>94</sup> See e.g., *Lindy Bros. Builders, Inc. v. American Radiator & Standard Sanitary Corp.*, 487 F.2d 161, 168 (3d Cir. 1973), *vacated after remand* 540 F.2d 102 (3d Cir. 1976). *Lindy Bros. Builders, Inc. v. American Radiator & Standard Sanitary Corp.*, 540 F.2d 102 (3d Cir. 1976).

<sup>95</sup> John C. Coffee, Jr., *The Unfaithful Champion: The Plaintiff As Monitor in Shareholder Litigation*, LAW & CONTEMP. PROBS., Summer 1985, at 38.

<sup>96</sup> See *id.*

<sup>97</sup> See generally Coffee, *supra* note 55, at 677-98.

substantial.

Another method of compensating attorneys for their efforts is to award them a percentage of the corporation's recovery.<sup>98</sup> Often, there is a recovery for the corporation, and the attorneys receive a large fee award, often for a minimal amount of work.<sup>99</sup> This is partially due to the way the statute is designed, since if all of the elements are met, there is generally no defense and the insider will have to turn over the profits.<sup>100</sup>

The individual plaintiff and other shareholders usually receive a minimum benefit in relation to the amount of the attorney fees.<sup>101</sup> While this has the effect of encouraging attorneys to monitor and enforce Section 16(b) violations, which is what Congress had in mind to police and deter insider trading,<sup>102</sup> the downside is that it encourages the attorneys to seek out a violation and find a plaintiff merely for the fees involved.<sup>103</sup> This results in overenforcement and opportunism by attorneys, which creates a negative image of the legal profession in the mind of the public.

### *B. The Dilemma - Crossing The Line*

Due to the relaxed standing requirement of Section 16(b), it has become a widespread practice of attorneys to either solicit shareholders of the corporation in which the short swing transaction occurred or to ask friends or family to purchase securities of the corporation in order to obtain standing and have the attorney provide their legal services. This rule creates an impetus for attorneys to pursue private enforcement of the securities law.<sup>104</sup>

There is an incentive for the attorney to prosecute suits that may not be meritorious or may be of little value to the shareholder or the company, simply to stimulate attorney fees.<sup>105</sup> In many of these cases, the attorney's financial incentive

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<sup>98</sup> See *Blum v. Stenson*, 465 U.S. 886, 900 (1984).

<sup>99</sup> See *Smolowe v. Delendo Corp.*, 136 F.2d 231, 241 (2d Cir. 1943).

<sup>100</sup> See generally *Coffee*, *supra* note 55 at 677-98.

<sup>101</sup> See *Smolowe*, 136 F.2d at 241.

<sup>102</sup> See *id.* See also 15 U.S.C. § 78p(b) (1994).

<sup>103</sup> See *Magida v. Continental Can Co.*, 231 F.2d 843, 848 (2d Cir. 1956)

<sup>104</sup> See *Portnoy v. Gold Reserve Corp.*, 711 F.Supp. 565, 569-70 (E.D. Wash. 1989).

<sup>105</sup> In *Portnoy*, a United States District Court, stressed the need for the attorney's role before recovery of fees. The corporation already had begun an investigation into an alleged §16(b) violation by the time that the plaintiff shareholder's letter notifying the corporation of the possible short swing transactions arrived. *Id.* at 566-67. The court noted that the

is the sole motivation for enforcement of Section 16(b).

The attorney basically becomes an entrepreneur or a "bounty hunter,"<sup>106</sup> not just an enforcer for an aggrieved or injured client or a deterrent to illegal conduct.<sup>107</sup> This situation allows a chance of opportunism and overenforcement on the part of the attorney.<sup>108</sup> The attorney generally has a low search cost in relation to the amount of money that he or she can make from these cases.<sup>109</sup> There is no defense to a violation, which basically makes this an ideal situation for the attorney. All the attorney must do is find a violation and a plaintiff, prove the elements of Section 16(b), and he has a fee.

One could argue that if the attorney does not have a motive (a substantial fee) to search out violations and enforce them on behalf of a client, who will do so? Since most potential plaintiffs own stocks through mutual funds, where they probably don't even know the names of the individual stocks, they will not take action to enforce Section 16(b).<sup>110</sup> It is likely that most small investors have no idea that they can bring action against the insider. Even if the small investor were aware, it is unlikely he would have the time, interest, or sophistication to do so. This is especially so considering the small monetary benefit to the individual shareholder.<sup>111</sup> Shareholders with a substantial interest in a company rarely try to

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corporation had informed the shareholder that it was pursuing the claim and waiting for a determination on the exact amount to be recovered. *Id.* at 566. However, after the sixty-day waiting period had expired the shareholder brought a derivative action to recover the illegal short swing profit. *Id.* at 567.

A few days later, the corporation notified the shareholder that it had secured the profits and settled the matter. *Id.* Thereafter the attorney for the shareholder requested the court to award him attorney's fees in prosecuting the action. *Portnoy*, 711 F. Supp. at 567. The court denied his claim, stating that "an award is equitable only if the attorney's services were a substantial or motivating factor in the corporation's recovery in the illegal profit," and in this case he was not because the corporation had informed the shareholder that it was pursuing the alleged violation. *Id.* at 569.

<sup>106</sup> See 15 U.S.C. §78u-1(e) (1994). For SEC procedures relating to bounty hunter provisions, see 17 C.F.R. §§201.61-201.68 (1997).

<sup>107</sup> See generally *Coffee*, *supra* note 55.

<sup>108</sup> *Id.*

<sup>109</sup> *Id.*

<sup>110</sup> See generally Michael H. Dessent, *Joe Six-Pack*, *United States v. O'Hagan and Private Securities Litigation Reform: A Line Must Be Drawn*, 40 ARIZ. L. REV. 1137, 1207-1217 (1998).

<sup>111</sup> See generally *id.*



enforce Section 16(b).<sup>112</sup> If the corporation, which is more than likely aware of the trades involved, does not care to take action against the insider, no one is left to do so.<sup>113</sup>

However, new federal legislation allowing private causes of action for contemporaneous trader involving insider trading provide a clear consistent framework for enforcement in this field. The major problem of Section 16(b) or following Fed. R. Civ. P. 23.1 is solved as well. Champerty is eliminated. The defendant must have scienter, and the SEC or individual plaintiff is allowed to recover if a violation of Rule 10(b)5 is proven. Thus, Section 16(b) has essentially become moot, or at worst, much more of a problem than a solution.

## VI. THE POOR PLAINTIFF

### A. *Where's the Money?*

Since attorneys receive large amounts for their fees and the shareholder who is supposed to be the one with an interest in the litigation usually does not really increase his personal equity, is the purpose of this act being accomplished?.

The extreme disallocation of any proceeds can be extraordinary. In one case the attorney was awarded \$3,000 for fees and \$78.98 for expenses to be paid by the corporation.<sup>114</sup> The recovery against the defendants was \$18,894.85.<sup>115</sup> The plaintiffs were only benefitted by about \$3 since they owned only 150 shares out of 800,000.<sup>116</sup>

In another case, the plaintiff shareholder sought to increase his personal equity by \$1.10 if the Section 16(b) action was successful,<sup>117</sup> while if he were unsuccessful he would be responsible for costs and expenses adding up to many hundred times that amount.<sup>118</sup> Subsequently, in a later action the attorney petitioned the court for an allowance of 50 percent of the recovery.<sup>119</sup>

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<sup>112</sup> See *Magida*, 231 F.2d at 847.

<sup>113</sup> See *id.* at 848.

<sup>114</sup> *Smowlow v. Delendo Corp.*, 136 F.2d 231, 241 (2d. Cir. 1943).

<sup>115</sup> *Id.* at 240.

<sup>116</sup> *Id.*

<sup>117</sup> *Magida v. Continental Can Co.*, 231 F.2d. 843, 847 (2d Cir. 1956).

<sup>118</sup> *Id.*

<sup>119</sup> *Magida v. Continental Can Co.*, 176 F. Supp. 781, 782 (S.D.N.Y. 1956).

The court noted that the services rendered by the attorney were both necessary and beneficial to the corporation; however, it was found that this amount was excessive. As a result, the court granted an allowance of \$12,000, approximately one quarter of the total amount recovered, which it felt was fair and adequate to cover his services.<sup>120</sup>

It was argued that this would be unfair considering the discrepancy between what the attorney received as a benefit versus what the actual plaintiff received. However, in the Court's reasoning it stated that the corporate issuer is the one who usually brings forth the action and only upon its refusal or delay does the shareholder have the right to act.<sup>121</sup> The Court reasoned that a stockholder who is successful in maintaining a Section 16(b) action was entitled to reasonable attorneys' fees because it was the corporation which had received the benefit of the attorney's work and, therefore, should pay for such a benefit.<sup>122</sup> Since the corporation is the one which has received the benefit, it must pay for the services.

An arguable question which arises is what is the purpose of having a shareholder plaintiff? The only ones really benefitting are the corporation and the private attorney who worked on the case when the corporation failed to do so. In some cases the attorney is the only one who benefits because, while the corporation may receive the proceeds of the short swing profit due to the work of the attorney, it also has to pay out large sums for attorney's fees and costs.

For example, in one case a court granted the attorneys \$750,000 in fees but the amount recovered was \$7,920,000.<sup>123</sup> Originally, the attorneys petitioned for \$2,500,000; however, the court found this to be unreasonable. It decided that the notion that a fee based primarily on a percentage of the recovery exceeded the limits of reasonable compensation for the attorney's efforts.<sup>124</sup>

It seems as though whether you are a bonafide shareholder or a friend who has bought into the action, the court is not interested. As long as the corporation receives a benefit from the attorney's work, the theory is that every shareholder receives a benefit. An example of this is where a case settles before going to trial and the attorney cannot even account for all of his time spent on the case.<sup>125</sup>

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<sup>120</sup> *Id.* at 783.

<sup>121</sup> *Id.*

<sup>122</sup> *Id.*

<sup>123</sup> *Newmark v. RKO Gen., Inc.*, 332 F.Supp. 161 (S.D.N.Y. 1971).

<sup>124</sup> *Id.* at 163.

<sup>125</sup> *See id.* at 164.

When the issue of avoiding trial has arisen, the courts have been willing to award more than one third the amount of recovery in attorney's fees simply because the case settled.<sup>126</sup> One court awarded \$10,000 in fees to attorneys in relation to work done on the case, even though they could not show the actual amount of time spent.<sup>127</sup> The court based its reasoning on the fact that the fees were reasonable and fair, based on the results achieved by the intervention of counsel.<sup>128</sup>

Also, under circumstances when the attorney has merely aided in the discovery of short swing profits, attorney's fees have been awarded. In *Gilson v. Chock Full O'Nuts Corporation*,<sup>129</sup> the Second Circuit allowed an award to an attorney who had merely brought the violation of Section 16(b) to the attention of the corporation, who later brought suit.<sup>130</sup> The case was appealed from the United States District Court which dismissed the complaint for attorney's fees. The Court of Appeals cited *Smolowe v. Delendo Corporation*, which recognized that reimbursement of attorney's fees was required by equitable considerations.<sup>131</sup>

One of the problems with identifying champertous agreements is the question of whose interest is being pursued. For example, when an attorney enters into a contingent fee agreement the attorney is highly motivated personally to win the case and receive a share of the judgment. If the client has paid the costs, the attorney maintains the client's interest in pursuing the case, so that he may profit only from judgment, but not be motivated to prosecute the action solely to obtain his fee.

Technically in a champertous agreement, the attorney puts his interest first because he has more at stake. Not only is the attorney trying to win the case to receive his share for the work that he has performed, but he needs to recoup the money that he has put out for costs. Therefore, the shareholder becomes the vehicle through which the attorney initiates the case and recovers fees.

In this latter arrangement, the shareholder is no longer relevant after the case has begun, because the needs which the attorney seeks to address are his own.

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<sup>126</sup> *Blau v. Kagan*, Fed. Sec. L. Rep. (CCH) ¶ 92, 119, at 96,561 (S.D.N.Y. Jan 8, 1968).

<sup>127</sup> *Id.*

<sup>128</sup> *Id.*

<sup>129</sup> 326 F.2d 246 (2d Cir. 1964), *aff'd on reh'g en banc*, 331 F.2d 107 (2d Cir. 1964).

<sup>130</sup> *Id.* at 248.

<sup>131</sup> *Id.*

This practice is held to be unethical.<sup>132</sup> The rules relating to ethics state that an attorney shall not acquire a proprietary interest in a cause of action or litigation.<sup>133</sup> It has been argued that the attorney has put himself in a position of primary interest in the cause of action or subject matter of the litigation that he is conducting for the client, when he has based his fee on the success of the case.

In addressing this issue the courts have balanced the interests of the corporation's many shareholders versus the self-seeking attorney. The Court in *Magida v Continental Can Company* stated,

Presumably Congress is aware of the opportunity presented to attorneys to suits for their benefit, but apparently it regards public policy against proved and repeated violations of fiduciary responsibility by corporate offices at the expense of the public more detrimental to public good than the violation of generally accepted ethics by attorneys.<sup>134</sup>

Thereby, it set the standard that champertous agreements would not be a defense to Section 16(b) actions, but, if proven, would only be pertinent to the determination of the amount of the award granted to the attorney. Since courts are willing to award attorney's fees even in cases where counsel has acted unethically,<sup>135</sup> it is possible to see how attorneys may take great steps to become involved in Section 16(b) actions. After all, even if they act inappropriately, their actions are not a defense to the action. Further, the only harm they may suffer is a reduction in the amount of fees they receive. Tragically, the issue of impropriety becomes irrelevant.

### *B. Solicitation*

One key problem with Section 16(b) is that solicitation of legal representation by an attorney from existing holders of securities violates long-standing established principles.<sup>136</sup> The rules on professional responsibility state that a lawyer shall not, except in some permitted forms of advertising, recommend employment as a private practitioner, of himself, his partner, or associate to a

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<sup>132</sup> See generally Gabaldon, *supra* note 88, at 466-69.

<sup>133</sup> MODEL RULES OF PROFESSIONAL CONDUCT RULE 1.8(j) (1998); MODEL CODE OF PROFESSIONAL RESPONSIBILITY DR 5-103(A) (1981).

<sup>134</sup> *Magida v. Continental Can Co.*, 176 F. Supp. 781, 783 (S.D.N.Y. 1956).

<sup>135</sup> See *id.*

<sup>136</sup> See MODEL CODE OF PROFESSIONAL RESPONSIBILITY DR 2-103(A) (1981).

layperson who has not sought his advice regarding the employment of a lawyer.<sup>137</sup>

When this issue has arisen, the judicial attitude has been that the ends of Section 16(b) enforcement justify means that may involve technical improprieties. In fact, courts have uniformly held that an attorney's solicitational acts may be grounds for disciplinary action, but will not suffice as a defense for a Section 16(b) action.<sup>138</sup>

Thus, attorneys who read a report filed with the SEC may try to solicit those who own shares of the corporation to initiate an action, since it is the attorney who receives a fair share of the recovery. Attorneys may even ask friends, family or employees to buy shares, thus giving them standing, and the attorney employment on the case.

In *Blau v. Rayette-Faberge, Incorporated*,<sup>139</sup> the court stated the policy for such a conclusion

We do not suggest that counsel fees should be automatically awarded to overzealous attorneys; nor do we want lawyers poring over Section 16(a) reports as soon as they are made public to find a cause of action before the corporation does and thereby collect a fee. Reimbursement for information leading to corporate recovery will be allowed only if the corporation has done nothing for a substantial period of time after the suspect transactions and its inaction is likely to continue. In this way, it is not speed but careful investigation which will be rewarded, and the corporation will have adequate opportunity to enforce its rights without prodding from a stockholder. But if the corporation has been, and is likely to be, inattentive to its rights, a portion of any recovery should properly go to the stockholder for reimbursement of any reasonable legal expenses.<sup>140</sup>

Another issue is that of soliciting an intimidated or co-conspirator employee, family member or friend to buy into the action. While a lawyer may be considered to have an attorney/client relationship with a close friend or relative resulting merely from advice given, it is unlikely that "advice," in this context, includes asking a friend or family member to buy into a cause of action. This type

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<sup>137</sup> *Id.*

<sup>138</sup> See Gabaldon, *supra* note 88 at n.87.

<sup>139</sup> 389 F.2d 469 (2d Cir. 1968).

<sup>140</sup> *Id.* at 473.

of solicitation usually translates into the attorney acquiring an interest in the litigation, since it is not the friend or relative who has any interest in the outcome of the action. The attorney is the only one who really stands to benefit by receiving his fees.

## VII. PROPOSALS FOR CHANGE

It is argued that repeal is needed in this area of securities law enforcement for three reasons. First, proper theories exist to meet Congress' intent. Second, society needs to curb the excessive and unnecessary litigation that is rampant in this area of the law. Third, the bench and bar should help to restore the badly tarnished image of attorneys and the legal profession. In order to cause changes in this area of the law, it is necessary to examine the circumstances that make it possible for attorneys to indulge in unnecessary litigation merely to collect fees. These circumstances involve the issue of standing of the plaintiff.

The standing requirements of Section 16(b) are quite broad in relating to securities laws. This is evident by the fact that a person can obtain standing by acquiring the stock after the alleged trade has taken place, and such a person does not need to own any certain amount of shares to initiate the suit. One share of stock is enough to confer standing.<sup>141</sup>

Further, Section 16(b) states that "any security" will be adequate to confer standing.<sup>142</sup> Examples of such securities include stocks, notes, warrants, bonds, debentures, puts, calls and others.<sup>143</sup> The only restriction is currency or any note, draft, bill of exchange, or banker's acceptance which has a maturity at the time of the issuance not exceeding nine months.<sup>144</sup> Due to the ease with which a person can become a party to the suit, amending the law may be the only alternative to cure the ongoing abuse by plaintiff's attorneys.

There are several theories with which to amend Section 16(b). They

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<sup>141</sup> Gollust v. Mendell, 501 U.S. 115, 127 (1991).

<sup>142</sup> 15 U.S.C. § 78p(b) (1994).

<sup>143</sup> THOMAS LEE HAZEN, *THE LAW OF SECURITIES REGULATION*, 408 & n.1 (3d ed. 1996) (stating that "[t]he registration requirement [of securities] is set forth in section 12(g), 15 U.S.C. § 78l(g) (1994)."). See generally Donald A. Scott, *Checklist for Registration of Securities under Section 12(g) of the Securities Exchange Act of 1934*, 25 BUS. LAW. 1631 (1981).

<sup>144</sup> 15 U.S.C. § 78c(a)(10) (1994).

include: (1) eliminating private causes of action, (2) banning contingent fees, or (3) changing the category of possible plaintiffs by requiring them to be shareholders at the time of the trade. In the alternative, the decision in *United States v. O'Hagan*<sup>145</sup> may set the standard, thus repudiating the need for Section 16(b) at all.

#### A. *Eliminate Private Causes of Action?*

Under Section 16(b) a shareholder may initiate a suit for insider trading sixty days after notifying the corporation, if the corporation fails to act. By virtue of this rule, all the shareholder has to do is wait the sixty days and then initiate his suit to recover the short swing profits. Attorneys, as discussed in the section above, use this time to investigate and research, all of which may lead to the discovery of a violation of Section 16(b). They are compensated for all work done, which facilitates the recovery of short swing profits.

In the best scenario to justify the lawyer's role, the corporation fails to act within the sixty-day period and the attorney initiates the law suit, increasing the amount of compensation he receives for the return of profits by the insider proprietary figure. If an insider is taking advantage of his position and making illegal trades, why not allow the interested shareholder to seek him out and make him divulge any profits made?

While in theory this sounds ideal, reality is that the shareholder is usually not the one with real interest in retrieving those profits. It is the attorneys who facilitate the suit. They are the ones who profit from the initiation of a law suit. By eliminating private causes of action, attorneys would not be able to take advantage of the lenient standing requirement. There would be no involvement of private attorneys for the sake of retrieving short swing profits.

While this approach may seem unfair, many other securities laws give the enforcement of such laws to the Securities and Exchange Commission. Section 16(b) is one law which Congress chose not to give such authority. Since 16(b) requires the shareholder to notify the corporation first, Congress may have thought that the issue would be settled internally by the corporation. The fact that it allowed the shareholder to take action sixty days after notifying the corporation may have been to simply put a threat on the corporation.

In many of the cases, when the corporation fails to take action within time

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<sup>145</sup> 521 U.S. 642 (1997).

allotted, and the shareholder initiates a suit, the case settles before litigation.<sup>146</sup> This may be a reflection of what was intended, a quick resolution if the corporation failed to act on its own. The notion of plaintiff attorney's fees was never even considered by Congress. There is no mention in Section 16(b) of attorney's fees.

The courts have developed their own standard for determining what are reasonable attorney's fees. Had Congress known how widespread this practice of receiving attorney's fees for private causes of action, it may have granted the SEC the power to enforce Section 16(b) violations.

Another possibility is for Congress to allow the Securities and Exchange Commission to enforce Section 16(b), instead of private plaintiffs. There are two ways that this could be accomplished. The first method would be to simply allow the Securities and Exchange Commission (SEC) to enforce Section 16(b) instead of private plaintiffs. If violations were pursued by the Securities and Exchange Commission only, instead of private plaintiffs, there would be no attorney fees to be collected. A flat percentage of the recovery, such as twenty percent, could be paid out of the recovery to the Securities and Exchange Commission to fund the enforcement. This would leave the corporation with the majority of the recovery, although that fee may not cover the actual cost of recovery by the Securities and Exchange Commission. This would eliminate the lucrative plaintiff's bar that has developed in this area. The Securities and Exchange Commission would be as aggressively motivated in seeking out violations as would a private attorney with a monetary incentive. It also has the financial resources to do so.

Thus, the solution may lie in vesting the power to enforce Section 16(b) violations in the SEC. By allowing the SEC to be the enforcer of such violations, the shareholder would not have the burden of paying the costs of the suit in cases where the corporation has failed to act. Furthermore, the SEC would not have a personal stake in the outcome of the case. This may insure an unbiased representation of the shareholder in retrieving short swing profits. Lastly, this is another alternative which may cure ongoing abuse by attorneys.

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<sup>146</sup> See DAVID L. RATNER, *SECURITIES REGULATION IN A NUTSHELL*, 265 (6th ed. 1998) (stating that usually, a favored defense tactic to obtain a dismissal of derivative actions is to create a committee of "disinterested" directors. If, when this committee decides that it is not in the "best interest of the corporation" to maintain this action brought forth by a shareholder, it asks the court to dismiss the action. Therefore, in many cases settlement results before litigation occurs.)



### *B. Allow Champerty as a Complete Defense?*

To allow a complete defense of champerty would defeat the purpose and intent of Congress in effectuating the enforcement of Section 16(b). Even though an individual plaintiff would not receive a large increase in the value of his or her stock and the attorney would receive a significant amount, to allow otherwise would control the enforcement of Section 16(b).

If Congress were to apply Fed. R. Civ. P. 23.1 or Section 10(b) contemporaneous trade standard, so the plaintiff must be the owner of any security of the issuer at the time of the alleged insider trading and at the time that the suit is instituted, it would solve a major weakness in the statute. This would make finding a willing plaintiff more difficult since the number of possible plaintiffs is limited to only those who had a genuine interest in the company, which would cut down on the number of Section 16(b) actions undertaken. Also, this would reduce the number of actions that were pursued only for the interest of the attorney who found the violation, as it would require more work on the part of the attorney to find a willing plaintiff.

In conclusion, if Section 16(b) were amended to grant the SEC the task of enforcing Section 16(b) insider trading rather than private parties, this could well cure the problem of overzealous attorneys.

Attorney's fees would still provide the main stimulus for enforcing Section 16(b), but it would now require the attorney to find a "real" plaintiff, not one who purchased the stock after the short swing trading merely in order to benefit him or herself. This would provide a balance between the opposing interests involved. The attorney still has the opportunity to generate fees by pursuing Section 16(b) violations, but this will further the intent of Congress in encouraging private enforcement. The prosecution of Section 16(b) may drop slightly, but the ones not pursued would be the type of actions to be discouraged. There will still be a large recovery for the attorney, but he or she will have to travel further to reach it.

### *C. Change the Standing Tests?*

Another requirement under Section 16(b) is that the plaintiff must be the "owner of any security."<sup>147</sup> The term "any" share has been found to mean at least one share.<sup>148</sup> Other cases have held that there is no restriction on the number of

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<sup>147</sup> 15 U.S.C. § 78p(b) (1994).

<sup>148</sup> *Gollust v. Mendell*, 501 U.S. 115, 127 (1991).

shares, the percentage of shares, or the value of the share(s).<sup>149</sup> This results in potential plaintiffs with a very minimal interest in a company, who have the power to enforce Section 16(b).<sup>150</sup> The requirement of allowing a plaintiff standing who only owns a negligible number of shares seems unreasonable. To require more shares or a larger percentage of shares would still allow small shareholders who are truly aggrieved to enforce Section 16(b). The problem of how many shares remains. However, the current requirements for standing creates a situation that may be exploited to the detriment of the legal profession. The standing requirement of a minimal number of shares combined with the requirement that the plaintiff need only have an interest at the time the suit is instituted, has resulted in a situation where attorneys can seek out a violation, find a plaintiff to buy a single share, and enforce Section 16(b) solely to earn a fee.

*D. Modify Section 16(b) to include Fed. R. Civ. P. 23.1?*

A possible solution to cure the problem of attorney solicitation of current shareholders and friends or family who purchase shares to obtain standing, may be to require the shareholder to own their shares at the time of the alleged inside trade. Fed. R. Civ. P. 23.1 states that, in a derivative action brought by one or more shareholders to enforce the right of a corporation who has failed to enforce the right, the complaint shall be verified and shall allege "(1) that the plaintiff was a shareholder or a member at the time of the transaction of which the plaintiff complains."<sup>151</sup>

Modifying Section 16(b) to include Fed. R. Civ. P. 23.1 could prevent the fabricated cases which arise with overzealous attorneys. If the statute required contemporaneous ownership then, only those stockholders who had shares in the corporation at the time of the alleged trade would have standing, thus reducing the number who would have standing.

This would eliminate the practice of attorneys soliciting friends or family to buy into these actions. Shareholders who purchase shares of the corporation after the alleged trade has taken place would not be able to bring suit on behalf of themselves and the other shareholders.

Denying an after-the-fact shareholder the right to sue because he was not a shareholder at the time the trade appeared does not contradict the policy behind

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<sup>149</sup> *Id.* at 123.

<sup>150</sup> *See id.* at 125-26.

<sup>151</sup> FED. RCIV. P.23.1.

Section 16(b), which was designed to allow legitimate plaintiffs to initiate a suit for the good of the corporation as a whole. The corporation thus remains the primary beneficiary of the disgorged funds.

Thus, requiring plaintiffs to be shareholders at the time of the trade appears to be the solution to attorney impropriety.

### *E. Eliminate Certain Types of Attorneys' Fees?*

Section 16(b) does not specifically provide for the granting of attorney's fees. Courts have held that fees are justified in the majority of cases, for several reasons; first, fee awards may be the sole stimulus for the enforcement of Section 16,<sup>152</sup> and second, if the corporation receives a recovery, a benefit has been conferred on it,<sup>153</sup> and it should pay the reasonable value of the services that resulted in the recovery.

This leaves the amount of the fees as the major issue. In *Gilson v. Chock Full O'Nuts*, the court held that "equitable considerations require the corporation to pay a reasonable attorney's fee."<sup>154</sup> In *Smolowe*, the court found that "since in many cases such as this the possibility of recovering attorney's fees will provide the sole stimulus for the enforcement of Section 16(b), the allowance must not be too niggardly."<sup>155</sup> It appears that the attorney fees should be particular to each specific case, since the work required for each one may differ as far as effort, difficulty, and time expended. It would be unfair to deny an attorney payment for his services that conferred a benefit on another.

This would chill the enforcement of Section 16(b). However, the fees should be reasonable (in other words, not excessive) in light of the circumstances of each particular case. Shareholders generally do not have the money to institute the suit. Attorneys have become the force behind the initiating and pursuing of these suits. In cases where attorneys have asked a friend or co-worker to buy shares to obtain standing, it would be unlikely for their attorney to then ask for a retainer to pursue the case that they created in the first place.

Another solution to the problem of attorney interest may be to eliminate contingent fee arrangements. If a shareholder wished to investigate a possible

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<sup>152</sup> *Blau v. Rayette-Faberge, Inc.*, 389 F.2d 469, 472 (2d Cir. 1968) (citing *Smolowe v. Delendo Corp.*, 136 F.2d 231 (2d Cir. 1943)).

<sup>153</sup> *See id.* at 474.

<sup>154</sup> *Gilson v. Chock Full O'Nuts*, 326 F.2d 246, 248 (2d Cir. 1964).

<sup>155</sup> *Smolowe v. Delendo Corp.*, 136 F.2d 231, 241 (2d Cir. 1943).

Section 16(b) violation, he would have to obtain the services of an attorney through a retainer agreement. This would eliminate the solicitation by attorneys who ask friends to purchase shares to secure standing, since those who purchased the shares to allow the attorney to pursue the case would not be willing to pay for the suit.

This would eliminate abuses by attorneys who have a self-interest in Section 16(b) actions, but not affect those shareholders who honestly want to initiate a suit based upon a Section 16(b) violation. In this circumstance, the shareholder who has discovered a possible short swing trade would still be able to pursue the case.

Moreover, the court has the final determination on whether to award attorney's fees. In most cases, only where the attorney's work has been a motivating factor in the recovery of profits and where their work has substantially benefitted the corporation will the court award attorney's fees, thereby placing conditions on whether to grant fees for the work performed.

The court also has in its discretion the power to reduce the amount of the fees sought by the attorney who litigated the action.<sup>156</sup> In cases where a compromise has been reached as to the amount the insider will furnish to the corporation, the parties can stipulate to the dismissal of the action and attorney's fees. Although this amount is not binding on the court, the court may ask the SEC for an opinion on the appropriateness of the award requested.

Ordinarily, the SEC makes a recommendation as to how much it believes the attorney should receive in fees. In some cases the court does not follow either proposal. For example, in *Blau v. Brown & Western Nuclear, Incorporated*,<sup>157</sup> the parties stipulated to an amount of \$11,250 for attorney's fees.<sup>158</sup> The SEC recommended \$3,800 or ten percent of the recovery and the court awarded \$7,500.<sup>159</sup> In another case, the parties agreed to \$3,000 in attorney's fees.<sup>160</sup> While the SEC suggested \$1,000, the court awarded \$1,800, twenty percent of the recovery.<sup>161</sup>

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<sup>156</sup> See generally *Newmark v. RKO Gen., Inc.*, 332 F.Supp. 161 (S.D.N.Y. 1971).

<sup>157</sup> Fed. Sec. L. Rep. (CCH) ¶ 92,263, at 97,253 (S.D.N.Y. Sept. 4, 1968).

<sup>158</sup> *Id.*

<sup>159</sup> *Id.*

<sup>160</sup> *Blau v. Berkey Photo, Inc.*, Fed Sec. L. Rep. (CCH) ¶ 92,264, at 97,255 (S.D.N.Y. Sept. 4, 1968).

<sup>161</sup> *Id.* at ¶ 97,256.

This area presents difficulty because a set formula would be unfair to some attorneys, and a percentage of the recovery would be unfair to a corporation for what little legal work was done. The matter of fees is individual to each case and they are often excessive, but the solution is for courts to use an increasing percentage of the recovery based on the time and the difficulty of its collection. The court would have to determine what a reasonable plaintiff in the field of securities litigation would pay an attorney on an hourly basis and estimate the reasonable number of hours that an experienced attorney would need to complete the recovery.

The reasonable hourly rate would be calculated based on the geographical area, skill, difficulty of the work and factors as those found in the Model Rules of Professional Conduct. This option has several drawbacks. First, the court would be put in the position of monitoring the current market rate for attorney fees, which would take up judicial time. Theoretically, the required reasonableness of the fees based on the amount of the work actually done should reduce the number of attorneys who pursue a Section 16(b) violation simply to run up excessive fees. This may reduce the incentive for private enforcement of these violations, but if there were truly an un-addressed violation, an attorney would still be able to be paid at his usual hourly rate, as long as it was reasonable.

It seems arguable whether the courts have truly balanced the windfall to plaintiff's attorneys versus the small recovery for the shareholder. One theory concerning the contingent fees is that only cases are brought which have merit.<sup>162</sup> Attorneys will assess the chance of the suit's success before instituting the suit, based on the premise that in the event that it is not successful, they will not be paid. However, the reoccurring danger exists of whose interests are being pursued.

The courts have effectively addressed this issue and placed the value of recovery in Section 16(b) cases higher than the self-interested attorney. It is not to say that the impropriety of plaintiff's attorneys does not exist, but the courts have decided that the inherent goal of Congress in enacting Section 16(b) for the good of the public outweighs all else.

However, the elimination of contingent fee arrangements would not disregard Congressional intent. Section 16(b)'s silence on the matter of attorney's fees, leads to the conclusion that Congress may have thought that since the law was written bestowing strict liability on those who violate it, there would not be much litigation. They may have thought that if the insider did not turn over any profit

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<sup>162</sup> See Gabaldon, *supra* note 88, at 459.

made within the six-month period, the corporation would ensure that the profit was disgorged. However, because attorneys' fees are not mentioned in the statute, leads to an argument that they should not be awarded.

*F. Eliminate Section 16(b) Altogether?*

Section 16(b) has been criticized for several reasons.<sup>163</sup> The first is that it only applies to a defined group of directors, officers, and beneficial owners.<sup>164</sup> Section 16(b) does not apply to others within the company who may have access to valuable information. It also applies to the defined group, who may not even have access to information, but may still be penalized for trades not motivated by inside information.

Second, Section 16(b) applies only to insiders of equity securities registered with the Securities and Exchange Commission.<sup>165</sup> It does not apply to insiders of corporations that are not required to register, even though those insiders may engage in short swing trading.<sup>166</sup> Another criticism of Section 16(b) is that it does not require an insider to use inside information, but only considers whether the trades were within a six-month period and whether a profit may be calculated. Actually, this discourages insiders from owning securities issued by their company.<sup>167</sup> Contrariwise, it does not affect trades that are outside the six-month window, even if they were motivated by inside information.<sup>168</sup>

One possible solution is to eliminate Section 16(b). There are other sources<sup>169</sup> which prohibit the use of inside information in securities trading, most of which are more efficient and fair to both the insiders and the trading public.

Two of these are Section 10(b) and Rule 10(b)5.<sup>170</sup> Section 10(b) is a

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<sup>163</sup> See Taylor, *supra* note 26, at 1318-19.

<sup>164</sup> See *id.* at 1322-26. See also 15 U.S.C. § 78p(b) (1994).

<sup>165</sup> See 15 U.S.C. § 78p(b) (1994).

<sup>166</sup> See *id.*

<sup>167</sup> See Taylor, *supra* note 26, at n.34.

<sup>168</sup> *Id.* at 1324.

<sup>169</sup> See *id.* E.g., 17 C.F.R. § 240.10b-5 (1997).

<sup>170</sup> Section 10(b) of the Securities Exchange Act of 1934 provides that, "It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or the mails, or any facility of any national securities exchange -- to use or employ, in connection with the purchase or sale of any security registered on the securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the [Securities and Exchange]

general fraud provision, which in conjunction with Rule 10(b)5 prohibits the use of material inside information when trading securities, until that inside information has been made available to the public.

These provisions apply to all interstate securities sales and purchases, regardless of the time frame, and not just to corporations that are required to register under the Securities Act of 1933.<sup>171</sup>

An insider violates Section 10b-5 if he trades in the securities issued by his company on the basis of material information that is not available to the public.<sup>172</sup> This section applies not just to traditional insiders such as officers and directors, but to people who may have access to inside information by having an indirect connection with the company, such as attorneys, accountants, and others who are temporarily connected with the corporation.<sup>173</sup> These people are considered fiduciaries.<sup>174</sup>

In order to be found in violation of Rule 10(b)5, an insider must have been in a fiduciary relationship with corporation.<sup>175</sup> Until recently, this meant that the person had to have a relationship with the company or the shareholders, thus establishing the duty.<sup>176</sup>

In 1980, the Supreme Court found that a printer, who traded on nonpublic information gained in conjunction with his employment, had no fiduciary relationship that required him to disclose information.<sup>177</sup>

In 1997 the Supreme Court decided the case of *United States v. O'Hagan*.<sup>178</sup> There, an associate in a law firm, retained to represent a company in an acquisition, became aware that a major tender offer was forthcoming. The associate purchased options in the securities in the corporation he acquired and made a substantial profit. The associate was convicted on multiple counts of securities fraud, mail

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Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors. 15 U.S.C. § 78j (1994).

<sup>171</sup> *See id.*

<sup>172</sup> Taylor, *supra* note 26, at 1328-29.

<sup>173</sup> *United States v. O'Hagan*, 92 F.3d 612, 619 (8th Cir. 1996), *rev'd*, 521 U.S. 642 (1997).

<sup>174</sup> *Id.*

<sup>175</sup> *See id.* at 617-18.

<sup>176</sup> *See generally* Chiarella v. *United States*, 445 U.S. 222 (1980).

<sup>177</sup> *See id.* at 235.

<sup>178</sup> 521 U.S. 642 (1997).

fraud, and money laundering. The Eighth Circuit Court of Appeals reversed because it found that the associate had no relation to the corporation and, therefore, had no duty to it. The Supreme Court reversed on the ground that even though the associate had no duty to the corporation, he still had a duty to his law firm, even though it had resigned from the case before the offers were conducted.<sup>179</sup>

This 'misappropriation' theory holds that a person commits fraud 'in connection with' a securities transaction, and thereby violates Section 10(b) and Rule 10b-5 when he misappropriates confidential information for securities trading purposes, in breach of a duty owed to the source of the information. In lieu of premising liability on a fiduciary relationship between a company insider and purchaser or seller of the company's stock, the misappropriation theory premises liability on a fiduciary-turned-trader's deception of those who entrusted him with access to confidential information.<sup>180</sup>

By comparison, Section 10(b) and Rule 10b-5 concentrate on singular securities, while Section 16(b) focuses on controlling a particular class of transactions.

The Court also noted that an insider who secretly converts the principal's information for personal gain, defrauds the principal. Further, the next requirement that needs to be proven, that the trade was "in connection with the purchase or sale of a security," is satisfied when without disclosure to the principal, the insider uses the information to purchase or sell securities.<sup>181</sup> Even more noteworthy, is that the holding includes not only officers, directors, and other permanent insiders of the corporation, but also attorneys, accountants, and others who temporarily become fiduciaries of the corporation.<sup>182</sup>

In the Section 16(b) situation, where an insider uses information he obtained due to his position and profits, he is deemed to have defrauded the corporation because there was a certain relationship of trust and confidence between the shareholders of the corporation and the insider. Therefore, the corporation, as well as the investing public, are harmed by his actions. It is this reason that the 1934 Congress enacted Section 16(b) in the first place, to try to preserve this sense of trust. When the insider uses this information to purchase or sell securities without informing the corporation, (including all shareholders) the second element is met,

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<sup>179</sup> See *id.* at 653.

<sup>180</sup> *Id.* at 652.

<sup>181</sup> *Id.* at 656.

<sup>182</sup> *Id.* at 652. See also 15 U.S.C. § 78p(b) (1994).



that of "in connection with the purchase or sale of a security."

In essence, the Rule 10(b)5 statute now is held to condemn (1) using of any deceptive device, (2) in connection with the purchase or sale of securities, in contravention of rules prescribed by the Commission.<sup>183</sup> The misappropriation theory permits the imposition of liability to a person who trades in securities for their personal benefit.<sup>184</sup> By using material, confidential information without first disclosing it to the public, the insider breaches the duty of loyalty and confidentiality, he owes to the principal.<sup>185</sup>

With *United States v. O'Hagan*,<sup>186</sup> the Court may have declared the final word on all insider trading. There may no longer be a need for two standards. All inside traders can be dealt with under the misappropriation theory. The Court held that criminal liability under Section 10(b) may be predicated on the misappropriation theory.

Thus, the advantage of using Section 10(b) and Rule 10(b)5 to control insider trading makes it easier to focus on the facts of an individual situation, rather than finding a whole class of securities trades improper. This would allow the plaintiff (or the Securities and Exchange Commission) to determine whether the trades were actually motivated by inside information. This has the advantage of allowing short swing trading by insiders when the trades are not motivated by inside information, but on personal financial situations, such as family situations, other investment opportunities, or unexpected bills, etc. These sections also have the advantage of not being applicable only to public corporation or statutorily defined insiders, since the laws are applicable to more trades which would advance Congress' intent in reducing insider trading.

One disadvantage of using Section 10(b) and Rule 10(b)5 to combat short swing insider trading is that it is more difficult to prove liability, which, in turn, makes for more expensive and time consuming litigation, thereby using up already strained judicial resources. Another drawback is that Rule 10(b)5 does not impose liability for trading on inside information unless there is a breach of fiduciary duty. This requirement would make it more difficult to prosecute short swing insider trading, but it is possible that the statute could be changed slightly to accommodate this.

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<sup>183</sup> *O'Hagan*, 521 U.S. at 651.

<sup>184</sup> *See id.* at 652.

<sup>185</sup> *See id.*

<sup>186</sup> 117 S. Ct. 2199 (1997).

## VIII. CONCLUSIONS

Insider trading continues to be an issue today. Those insiders who transact in short sales and who do not divulge their profits to the corporation are sought out and forced to return the profits. Whether it is a shareholder of the corporation who initiates the suit or an overzealous attorney who finds out about the trade and encourages a friend to purchase the security to obtain standing, one thing is clear, the insider will forfeit the profits if he violates Section 16(b).<sup>187</sup>

Section 16(b)<sup>188</sup> permits litigation merely for the sake of attorneys' fees, and it may not be as effective as other statutes in deterring and monitoring insider trading. While it is clear that this area of the law needs to be changed, the question of exactly how to change it without defeating the intent of Congress regarding the enforcement is a difficult one.

One key method of controlling excessive litigation would be to allow the Securities and Exchange Commission to enforce Section 16(b),<sup>189</sup> which would remove the incentive for attorneys to aggressively pursue violations.

Another method would be to eliminate Section 16(b)<sup>190</sup> entirely and use other statutes already in place to control short swing insider trading.

Amending Section 16(b)<sup>191</sup> to eliminate private causes of action, contingent fees or adding the contemporaneous ownership requirement of Fed. R. Civ. P. 23.1<sup>192</sup> to this section may also help. It has been argued that allowing the SEC to initiate suits where the corporation has failed to, may be a solution which would solve many of the existing problems. The SEC could pursue these suits, thereby eliminating the reward of large sums of the returned profits to the attorney. In the alternative, *O'Hagan*<sup>193</sup> may become the standard in cases dealing with insider trading.

Whatever the final result may be, there continues to be an ongoing problem of attorney impropriety in relation to Section 16(b) actions. If the intent of the

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<sup>187</sup> 15 U.S.C. § 78p(b) (1994).

<sup>188</sup> *Id.*

<sup>189</sup> *Id.*

<sup>190</sup> *Id.*

<sup>191</sup> *Id.*

<sup>192</sup> Fed. R. Civ. P. 23.1.

<sup>193</sup> *See supra* notes 177-184 and accompanying text.

Congress was to restore the integrity of the stock market and eliminate insider trading, then the *O'Hagan*<sup>194</sup> decision may be the best solution.

This paper has examined the statutory section of the Securities Exchange Act of 1934, § 16(b),<sup>195</sup> and attorney impropriety, an unforeseen issue which arose due to the relaxed standing requirements. The courts have weighed this problem with the overall purpose of Section 16(b) and found in favor of public policy. The reward to attorneys who do the job that should have been done by the corporation is too large a price to pay for the "benefit" conferred on the corporation and its shareholders.

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<sup>194</sup> *Id.*

<sup>195</sup> 15 U.S.C. § 78p(b) 1994.