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# THE NEW PRAGMATISM UNDER SECTION 16(b) OF THE SECURITIES EXCHANGE ACT

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Section 16(b) of the Securities Exchange Act, which provides for a corporation's recapture of short-swing profits realized by its officers, directors, and ten percent beneficial share owners, was enacted to present a "crude rule of thumb" or objective method of guarding against "the unscrupulous employment of [corporate] inside information."<sup>1</sup>

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1. *Hearings on S. Res. 84, S. Res. 56 & S. Res. 97 Before the Senate Comm. on Banking and Currency*, 73d Cong., 1st Sess., pt. 15, at 6557 (1934) [hereinafter cited as *Hearings*]; *accord*, SENATE COMM. ON BANKING AND CURRENCY, STOCK EXCHANGE PRACTICES, S. REP. NO. 1455, 73d Cong., 2d Sess. 1, 55 (1934). Section 16 provides in relevant part:

(a) Every person who is directly or indirectly the beneficial owner of more than 10 per centum of any class of any equity security (other than an exempted security) which is registered pursuant to section 78l of this title, or who is a director or an officer of the issuer of such security, shall file, at the time of the registration of such security on a national securities exchange or by the effective date of a registration statement filed pursuant to section 78l(g) of this title, or within ten days after he becomes such beneficial owner, director, or officer, a statement with the Commission (and, if such security is registered on a national securities exchange, also with the exchange) of the amount of all equity securities of such issuer of which he is the beneficial owner, and within ten days after the close of each calendar month thereafter, if there has been a change in such ownership during such month, shall file with the Commission (and if such security is registered on a national securities exchange, shall also file with the exchange), a statement indicating his ownership at the close of the calendar month and such changes in his ownership as have occurred during such calendar month.

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

Securities Exchange Act §§ 16(a)-(b), 15 U.S.C. §§ 78p(a)-(b) (1970). Various authorities have undertaken detailed analyses of the section's background and purpose. *See*,

Over a period of years the emphasis in judicial decisions has shifted from the objective application of the literal language of the statute to a more subjective, or pragmatic, case-by-case approach under which the short-swing purchases and sales are analyzed in terms of whether there existed the possibility of the type of speculative abuse to which the section directs itself. In conjunction with this metamorphosis the courts have to a large extent taken away a substantial degree of certainty and predictability in 16(b) situations. By 1971 one commentator recognized that this lack of predictability of result had produced confusion for courts attempting to find guidelines for applying the pragmatic approach and had thus created the need for clarification.<sup>2</sup> Concurrently, the courts were facing new fact settings, and these cases of first impression have thrown the subjective trend into a different phase—the new pragmatism.

Within two years of this call for clarification the Supreme Court, although twice having had the opportunity<sup>3</sup> to reinstate certainty in the application of section 16(b), has, if anything, added to and expanded the confusion. Subsequent decisions at the lower levels of the federal judiciary have further compounded the problem.

It is generally a questionable practice for the courts to proceed on an *ad hoc* basis at the sacrifice of creating clear precedential standards. This is especially critical when faced with judicial gloss on a seemingly objective statute. Furthermore, the current judicial trend in 16(b) cases becomes even more suspect when it is viewed in light of the contemporaneous case-by-case expansion of the implied private right of action under the Exchange Act's antifraud provisions.<sup>4</sup> It does not necessarily follow, however, that the courts should eschew the pragmatic trend, since the earlier objective application of the statute created its own anomalous results. A preferable response would be for the courts to

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*e.g.*, 2 L. LOSS, *SECURITIES REGULATION* 1037-44 (2d ed. 1961); Cook & Feldman, *Insider Trading Under the Securities Exchange Act* (pts. 1-2), 66 HARV. L. REV. 385, 612 (1953); Rubin & Feldman, *Statutory Inhibitions upon Unfair Use of Corporate Information by Insiders*, 95 U. PA. L. REV. 468 (1947). See also text accompanying notes 102-07 *infra*. For the suggestion that short-swing insider trading can have beneficial economic impact see Wu, *An Economist Looks at Section 16 of the Securities Exchange Act of 1934*, 68 COLUM. L. REV. 260 (1968).

2. Bateman, *The Pragmatic Interpretation of Section 16(b) and the Need for Clarification*, 45 ST. JOHN'S L. REV. 772 (1971).

3. Kern County Land Co. v. Occidental Petroleum Corp., 411 U.S. 582 (1973); Reliance Elec. Co. v. Emerson Elec. Co., 404 U.S. 418 (1972), *aff'g on other grounds*, 434 F.2d 918 (8th Cir. 1970).

4. Securities Exchange Act § 77q, 15 U.S.C. § 78j(b) (1970), and rule 10b-5 promulgated thereunder, 17 C.F.R. § 240.10b-5 (1974).

establish both a more consistent outlook in determining the intended thrust of the statute and more concrete guidelines for the applicability and application of the pragmatic method of analysis.

At the time of its enactment, 16(b) was the only section of the Exchange Act which created private damage actions to redress the misuse of confidential information by corporate insiders.<sup>5</sup> Twelve years after the passage of the Exchange Act, in what has since proven to be one of the most earth-shaking developments in federal securities law jurisprudence, a Pennsylvania district court ruled that a private civil remedy may be implied from the Act's antifraud provision and rule 10b-5 promulgated thereunder.<sup>6</sup> Subsequently rule 10b-5 has been greatly expanded to provide private damage actions against persons who trade in a corporation's stock under the guidance of inside information that is not available to the general investing public.<sup>7</sup> This is the type of situation with which section 16(b)'s framers were concerned. The development of rule 10b-5 as a viable retaliatory weapon for a purchaser or a seller who is a corporate outsider who has been injured by virtue of an insider's abuse of confidential information and breach of fiduciary duty is of more than mere academic or historical significance.

Prior to 1968, when 10b-5's utility was uncertain, the desirability of extending section 16(b)'s coverage as far as was statutorily permissible was evident; but with 10b-5's development, the abolition of or at least a more narrow approach to 16(b) may well be called for.<sup>8</sup> In

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5. Cf. Act of May 27, 1933, ch. 38, tit. I, § 12(2), 48 Stat. 84 (codified at 15 U.S.C. § 771(2) (1970)) (which creates an action on behalf of the purchaser against one who sells a security by making a misstatement or omission of a material fact). See also Act of May 27, 1933, ch. 38, tit. I, § 17(a), 48 Stat. 84 (codified at 15 U.S.C. § 77q(a) (1970)) and Act of June 6, 1934, ch. 404, § 10, 48 Stat. 891 (codified at 15 U.S.C. § 78j(b) (1970)) (which render similar activity unlawful but do not expressly provide for private redress via a civil damage action).

6. *Kardon v. National Gypsum Co.*, 73 F. Supp. 798 (E.D. Pa. 1947); *Kardon v. National Gypsum Co.*, 69 F. Supp. 512 (E.D. Pa. 1946); see 15 U.S.C. § 78j(b) (1970); 17 C.F.R. § 240.10b-5 (1974).

7. See, e.g., *Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 495 F.2d 228 (2d Cir. 1974); *Financial Indus. Fund v. McDonnell Douglas Corp.*, 474 F.2d 514 (10th Cir. 1973); *Mitchell v. Texas Gulf Sulphur Co.*, 446 F.2d 90 (10th Cir.), cert. denied, 404 U.S. 1004 (1971); *Astor v. Texas Gulf Sulphur Co.*, 306 F. Supp. 1333 (S.D.N.Y. 1969); cf. *SEC v. Texas Gulf Sulphur Co.*, 446 F.2d 1301 (2d Cir. 1971); *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833 (2d Cir. 1968), cert. denied, 394 U.S. 976 (1969). See generally A. BROMBERG, *SECURITIES LAW: FRAUD, SEC RULE 10b-5* (1973); 6 L. LOSS, *supra* note 1, at 3558-646 (Supp. 1969); 3 *id.* at 1448-74; W. PAINTER, *FEDERAL REGULATION OF INSIDER TRADING* 97-316 (1968; Cum. Supp. 1974).

8. See, e.g., Lowenfels, *Section 16(b): A New Trend in Regulating Insider Trading*, 54 CORNELL L. REV. 45, 61-64 (1968); cf. *Gold v. Sloan*, 491 F.2d 729, 731 (4th Cir. 1974) (on petition for rehearing *en banc*). As a result of the emergence of the pragmatic trend: "There is no longer any reason for the federal courts to be harsh and

drafting the proposed Federal Securities Code, the American Law Institute recognized the arguments in favor of the repeal of the section but nevertheless went on to adopt and "codif[y] the most important areas of the Section 16(b) jurisprudence, [while] smoothing some of the rough edges . . . ."<sup>9</sup> This proposed legislation attempts to reobjectify the sanctions against short-swing insider profits while paying heed to the problems which were pointed out by the courts in their development of the pragmatic trend. In comparison to the SEC's goal of drawing clear lines and establishing at least some degree of certainty in other areas,<sup>10</sup> the "rough edges" of 16(b) have become more ragged under the judicial application of the pragmatic approach and the emerging new pragmatism.

### THE DEVELOPMENT OF THE PRAGMATIC TREND

Under the early jurisprudence the courts interpreted section 16(b) to call for an objective and mechanical application in every case. This approach began to erode and has now been transposed into a subjective or pragmatic trend, at least in certain types of factual settings.<sup>11</sup> It has been suggested that the present thrust of the pragmatic trend in section

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objective in interpreting and applying section 16(b). Everything that this section was designed to accomplish, and much more, is presently being accomplished under section 10b-5 and rule 10b-5." 54 CORNELL L. REV., *supra*, at 62-63. It has been suggested that the current expansion of 10b-5 can be seen as having eliminated the need for 16(b)'s strict liability approach. See ALI FEDERAL SECURITIES CODE § 1413, Comment 1 (Tent. Draft No. 2, 1973) [hereinafter cited as Proposed Code], quoted in note 9 *infra*.

9. Proposed Code § 1413, Comment 2, at 133. See *id.*, Comment 1:

The initial question is whether § 16(b) should be preserved at all. Some favor its repeal on several grounds: (a) that it is needlessly arbitrary to the point of being quixotic; (b) that it has acted as a trap for the unwary; (c) that the Commission has made insufficient use of its exemptive authority; and (d) that, most of all, the jurisprudence that has developed under Rule 10b-5 (and that is being codified in part) has rendered obsolete the concept of *automatic* recapture of *certain* short-term profits of *certain* insiders.

As will become evident from the discussion below, the "rough edges" have become ragged by the more recent decisions.

10. See, e.g., 17 C.F.R. §§ 230.144-147 (1974) (the new series 140 rules promulgated under the Securities Act which provide safe harbors from the statute's reach in an attempt to give corporate planners and legal counsel a star by which to navigate).

11. See 2 L. LOSS, *supra* note 1, at 1040-45, 1066-75; W. PAINTER, *supra* note 7, at 24-69 (1968), 6-18 (Cum. Supp. 1974); Bateman, *supra* note 2; Lang & Katz, *Section 16(b) and "Extraordinary" Transactions: Corporate Reorganizations and Stock Options*, 49 NOTRE DAME LAW. 705 (1974); Lowenfels, *supra* note 8; Munter, *Section 16(b) of the Securities Exchange Act of 1934: An Alternative to "Burning Down the Barn in Order to Kill the Rats,"* 52 CORNELL L.Q. 69 (1966); Note, *Insider Liability for Short-Swing Profits: The Substance and Function of the Pragmatic Approach*, 72 MICH. L. REV. 592 (1974). The cases illustrating this trend are also collected in Annot., 22 A.L.R. FED. 281 (1975).

16(b) cases did not actually emerge until 1965 in the Ninth Circuit's decision in *Blau v. Max Factor & Co.*,<sup>12</sup> wherein the court looked beyond the language of the statute to inquire into the question whether the transaction under scrutiny offered the defendant the opportunity for the type of speculative abuse at which the section is directed.<sup>13</sup> However, the origins of this approach can be traced back twenty-two years earlier—prior to the emergence of the objective 16(b) jurisprudence.

In 1943, the District of Columbia Circuit Court and the Supreme Court in *SEC v. Chenery Corp.*<sup>14</sup> took a pragmatic approach to section 17(b) of the Public Utility Holding Company Act of 1935,<sup>15</sup> that Act's counterpart to section 16(b) of the Exchange Act.<sup>16</sup> In *Chenery* certain

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12. 342 F.2d 304 (9th Cir.), *cert. denied*, 382 U.S. 892 (1965); see Lowenfels, *supra* note 8, at 50. While the author did acknowledge the subjective approach which had been taken earlier in *Ferraiolo v. Newman*, 259 F.2d 342 (6th Cir. 1958), *cert. denied*, 359 U.S. 927 (1959) (see text accompanying notes 24-25 *supra*) and *Roberts v. Eaton*, 212 F.2d 82 (2d Cir.), *cert. denied*, 348 U.S. 827 (1954) (involving a "no purchase" approach to stock acquired pursuant to a corporate reclassification), these decisions were viewed as "[o]ccasional aberrations" and "isolated opinions" departing from the objective analysis.

13. The issuer in the *Max Factor* case had outstanding two classes of common stock with the board of directors having the power to declare higher dividends on the Class A stock. The insider defendants who held the other class decided to sell part of their holdings and in order to make their stock more marketable exercised their conversion rights and received the Class A stock on a one-for-one basis, which they sold two months later. Since the two classes of stock were virtually identical and the conversion rights were unrestricted the court found that 16(b)'s remedy for short swing was not appropriate since "the exchange conferred no opportunity for speculative profit which appellees did not already enjoy." 342 F.2d at 308.

14. 318 U.S. 80 (1943), *modifying* 128 F.2d 303 (D.C. Cir. 1942).

15. Act of Aug. 26, 1935, ch. 687, tit. I, § 33, 49 Stat. 838.

16. See 15 U.S.C. § 79q(b) (1970) which provides:

(b) For the purpose of preventing the unfair use of information which may have been obtained by any such officer or director by reason of his relationship to such registered holding company or any subsidiary company thereof . . . within any period of less than six months, unless such security was acquired in good faith in connection with a debt previously contracted, shall inure to and be recoverable by the holding company or subsidiary company in respect of the security of which such profit was realized, irrespective of any intention on the part of such officer or director in entering into such transaction to hold the security purchased or not to repurchase the security sold for a period of more than six months. Suit to recover such profit may be instituted at law or in equity in any court of competent jurisdiction by the company entitled thereto or by the owner of any security of such company in the name and in the behalf of such company if such company shall fail or refuse to bring such suit within sixty days after request or shall fail diligently to prosecute the same thereafter; but no such suit shall be brought more than two years after the date such profit was realized. This subsection shall not cover any transaction where such person was not an officer or director at the times of the purchase and sale, or the sale and purchase, of the security involved, or any transaction or transactions which the Commission by rules and regulations may, as necessary or appropriate in the public interest or for the protection of investors or consumers, exempt as not comprehended within the purpose of this subsection.

officers and directors of Federal Water Service Corporation had purchased Federal's preferred stock which pursuant to a reorganization submitted to the SEC four months later would be converted into common stock. The SEC approved the reorganization on the condition that these insiders receive only their initial purchase price plus interest in lieu of participating in the exchange, on the grounds that in light of the policy behind section 17(b)—and 16(b) of the Exchange Act—their participation would have been “detrimental to the public interest” under section 7 of the Holding Company Act.<sup>17</sup> In reviewing the commission's holding, the court of appeals reversed on the basis of an early formulation of the speculative abuse test:

[T]he Commission proposes to annul, not transactions growing out of an abuse of inside information, but transactions as to which both buyer and seller were equally informed of the facts—not trading designed to take quick profits from short term market fluctuations, but trading for investment by one whose income depended at least in part upon the success of the corporation of which he was an officer.<sup>18</sup>

The court reached this result in part by referring to the legislative history of the Exchange Act provision.<sup>19</sup>

The Supreme Court concurred in the appellate court's rationale notwithstanding the fact that the book value of the common stock, while not necessarily indicative of what the market would bear, was “considerably greater” than the price paid by the insiders for their preferred shares. The Court reasoned that not only was there full compliance with all disclosure requirements, but the insiders “acquired their stock as the outside world did” and under the reorganization plan were to participate on the same basis.<sup>20</sup> The opinion does not indicate whether the result would have been different had it been clear at the time the reorganization was proposed that the common stock was in fact worth more than the price which the insiders had paid for the preferred. Nevertheless, the District of Columbia Circuit Court and the Supreme Court in *Chenery* were clearly zeroing-in on the question whether the insiders' transactions were subject to speculative abuse.

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Nothing in this subsection shall be construed to give a remedy in the case of any transaction in respect of which a remedy is given under subsection (b) of section 78p of this title [16(b) of the Exchange Act].

17. 15 U.S.C. § 79g (1970).

18. 128 F.2d at 310-11.

19. *Id.* at 308, 310.

20. 318 U.S. at 86.

## THE SHIFT FROM OBJECTIVISM TO PRAGMATISM

The most frequently cited example of judicial objectivism under rule 16(b) is found in the Second Circuit's post-*Chenery* decision in *Park & Tilford, Inc. v. Schulte*.<sup>21</sup> In that case the court of appeals relied on the section 3(a)(13) definition of "purchase," which includes "any contract to buy or otherwise acquire,"<sup>22</sup> in holding that the exercise of the conversion rights incident to Park & Tilford's redeemable convertible preferred stock, in anticipation of a previously announced redemption, constituted a "purchase" of the underlying common stock.<sup>23</sup> Eleven years after the *Park & Tilford* decision Justice Potter Stewart, speaking for the Sixth Circuit in *Ferraiolo v. Newman*,<sup>24</sup> rejected and looked beyond this literal interpretation of "purchase" to include any share acquisition and concluded:

The real effect of [the issuers'] call of the preferred for redemption was simply to force the surrender of the preference features . . . .

. . . .

[The insiders'] conversion of preferred stock into common was in a very real sense involuntary . . . [and] created no opportunity for

21. 160 F.2d 984 (2d Cir.), *cert. denied*, 332 U.S. 761 (1947).

22. 15 U.S.C. § 78c(a)(13) (1970) (emphasis added). In comparison, the ALI's Proposed Code expressly provides that "purchase" and "sale" as used within the section dealing with insiders' short-swing profits are not governed by the Code's general definitions of those terms. Proposed Code § 1413(f)(1). See also Proposed Code §§ 1413(f)(2)-(5), (g). In some instances the same concepts of "purchase" and "sale" pervade the proposed statute while in others special rules would apply to the section dealing with the recapture of short-swing profits. This pattern is explained in Proposed Code § 1413, Comment 8:

The following table shows the treatment of their several components in § 1413 (it must be remembered that making § 293(f) or (g) *inapplicable* for purposes of § 1413 means just that, not that § 1413(f)(1) declares that a particular transaction is or is not a sale);

	§293	Does §293 apply to §1413?	Where treated in §1413
(f) (1)	Conversion	Yes	(h) (1)
(f) (2)	Exchange	Yes	(h) (1)
(f) (3)	Merger, etc.	Yes	(h) (1)
(f) (4)	Security dividend	No	(f) (4)
(g) (1)	Gift	No	(f) (2)
(g) (2)	Transfer by death	Yes	No sale
(g) (3)	Termination of trust	Yes	No sale
(g) (4)	Pledge or security loan	No	(f) (3)
(g) (5)	Split	Yes	No sale
(g) (6)	Security dividend	No	(f) (4)

23. 160 F.2d at 987; *accord*, *Kogan v. Schulte*, 61 F. Supp. 604 (S.D.N.Y. 1945). Another case which is frequently cited for the objective approach is *Smolowe v. Delendo Corp.*, 136 F.2d 231, 235 (2d Cir.), *cert. denied*, 320 U.S. 751 (1943): "[T]he only remedy which its [16(b)]'s framers deemed effective . . . was the imposition of a liability based upon an objective measure of proof." See also, *e.g.*, *Gratz v. Claughton*, 187 F.2d 46 (2d Cir.), *cert. denied*, 341 U.S. 920 (1951).

24. 259 F.2d 342 (6th Cir. 1958), *cert. denied*, 359 U.S. 927 (1959).



profit which had not existed since 1948.<sup>25</sup>

Stewart was thus willing to look beyond the form of, and scrutinize the substance of, the transaction in question in order to determine whether it was subject to the type of abuse against which 16(b) was construed to be directed.

While the *Ferraiolo* approach was followed by the Eighth Circuit in a similar situation in which the call for redemption was at a price lower than the market price of the underlying common,<sup>26</sup> the objective approach continued as the Third Circuit reached the contrary result and found a "purchase" by relying on the *Park & Tilford* strict statutory construction.<sup>27</sup> By 1965, the SEC realized that there was need for clarification in this area. The next year rule 16b-9 was amended to exempt from the section's coverage the exercise of conversion rights of convertible securities.<sup>28</sup>

In contrast to the judicial treatment of convertible securities, another type of non-"garden variety" transaction was uncovered in the area of stock rights, options and warrants. The Second Circuit adopted the objective approach in the options area when it ruled that under the terms of section 3(a)(13) of the Securities Exchange Act the acquisition of stock rights from the issuing corporation *without consideration* could not properly be classified as a section 16(b) purchase.<sup>29</sup> While the courts continued to follow the *Park & Tilford* rationale by viewing the exercise of options as statutory purchases, the SEC responded by promulgating rule 16b-3 which provided an exemption for the exercise of certain warrants by insiders which had been acquired pursuant to employee incentive plans. However, considerable doubt was cast upon the rule's validity and its scope was subsequently restricted by amendment, leaving the courts to return to their previous position that the exercise of the warrant or option is a statutory "purchase."<sup>30</sup>

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25. *Id.* at 345-46. For an earlier application of the subjective approach see text accompanying notes 99-101 *infra*.

26. *Petteys v. Butler*, 367 F.2d 528 (8th Cir. 1966), *cert. denied*, 385 U.S. 1006 (1967).

27. *Heli-Coil Corp. v. Webster*, 352 F.2d 156 (3d Cir. 1965); *accord*, *Lynam v. Livingston*, 276 F. Supp. 104 (D. Del. 1967).

28. See 17 C.F.R. § 240.16b-9 (1974); *cf.* Proposed Code § 1413(h)(1), discussed at text accompanying note 92 *infra*. See generally Hamilton, *Convertible Securities and Section 16(b): The End of an Era*, 44 TEXAS L. REV. 1447 (1966).

29. *Shaw v. Dreyfus*, 172 F.2d 140 (2d Cir.), *cert. denied*, 337 U.S. 907 (1949).

30. See *Keller Indus., Inc. v. Walden*, 462 F.2d 388 (5th Cir. 1972) (exercise of option pursuant to employee plan is a purchase); *Bershad v. McDonough*, 428 F.2d 693 (7th Cir. 1970), *cert. denied*, 400 U.S. 992 (1971), *aff'g* 300 F. Supp. 1051 (N.D. Ill. 1969) (insider's granting of an option to purchase with shares put in escrow is a "sale"); *Silverman v. Landa*, 306 F.2d 422 (2d Cir. 1962) (receipt of an option to

The comparison between conversion and option rights thus presented a starting point for the courts and the commission to draw the line between a statutory purchase and an acquisition of securities which is not subject to the Act's short-swing proscriptions. In the former situation, the holder of convertible securities has an investment interest in the corporation substantially similar to that of the underlying stock; thus, under the modern view the courts look to the acquisition of the preferred security or convertible debenture rather than to the date of the conversion for purposes of applying section 16(b)'s remedial sanctions.<sup>31</sup> In contrast, an option holder has no present equity or other interest in the corporation but, rather, owns nothing more than the right to acquire such an interest at a future time; it is only at the time of the option's exercise that the optionee can become the holder of an equity security. Hence in this latter area the courts look to the date of exercise for the purpose of identifying a statutory purchase.<sup>32</sup>

Notwithstanding rule 16b-9 and the SEC's resolution of the specific question regarding the exercise of rights under convertible securities, the pragmatic approach continued to mushroom and make its way into

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purchase is not a statutory purchase); *Greene v. Dietz*, 247 F.2d 689 (2d Cir. 1957) (the validity of former rule 16b-3's exemption of acquisitions pursuant to an employee plan was questioned but a verdict for the defendant was upheld due to good faith reliance on the SEC's position); *Shaw v. Dreyfus*, 172 F.2d 140, 142 (2d Cir.), *cert. denied*, 337 U.S. 907 (1949) (exercise of warrant is a "purchase"); *Sonics Int'l, Inc. v. Johnson*, 387 F. Supp. 741 (N.D. Tex. 1975) (applying rule 16b-6's damage ceiling to stock acquired pursuant to the exercise of an employee option); *Volk v. Zlotoff*, 285 F. Supp. 650 (S.D.N.Y. 1968) (exercise of option is a "purchase"); *Kornfeld v. Eaton*, 217 F. Supp. 671 (S.D.N.Y. 1963) (upholding rule 16b-6's measure of damages); *Van Aalten v. Hurley*, 176 F. Supp. 851 (S.D.N.Y. 1959) (absolving insider of liability where he relied on rule 16b-3's exemption); *Continental Oil Co. v. Perlitz*, 176 F. Supp. 219 (S.D. Tex. 1959) (same); *Perlman v. Timberlake*, 172 F. Supp. 246 (S.D.N.Y. 1959) (same); *Emerson Elec. Mfg. Co. v. O'Neill*, 168 F. Supp. 804 (E.D. Mo. 1958) (same); *Blau v. Hodgkinson*, 100 F. Supp. 361 (S.D.N.Y. 1951) (exercise of warrant is a "purchase"); *Steinberg v. Sharpe*, 95 F. Supp. 32 (S.D.N.Y. 1950), *aff'd per curiam*, 190 F.2d 82 (2d Cir. 1951) (same); *Berkey & Gay Furniture Co. v. Wigmore*, 5 S.E.C. Jud. Dec. 442 (S.D.N.Y. 1947) (same). *See also* 17 C.F.R. §§ 240.16b-3, -6 (1974).

31. Short-swing trading in convertible debentures is subject to 16(b)'s sanctions as they are held to be "equity securities"; the determination of whether the holder of convertible debentures is a ten percent beneficial owner is made by reference to his or her percentage of the underlying stock assuming that all conversion rights have been exercised. *See, e.g., Provident Sec. Co. v. Foremost-McKesson, Inc.*, 506 F.2d 601, 603 (9th Cir. 1974), *cert. granted*, 420 U.S. 923 (1975); *Chemical Fund, Inc. v. Xerox Corp.*, 377 F.2d 107, 110-11 (2d Cir. 1967); *Simon v. Sunasco, Inc.*, [1969-1970 Transfer Binder] CCH FED. SEC. L. REP. ¶ 92,547, at 98,510-11 (S.D.N.Y. 1970); *cf. Ellerin v. Massachusetts Mut. Life Ins. Co.*, 270 F.2d 259 (2d Cir. 1959), where it was held that the issuer's preferred stock which was divided into two series with different dividend redemption and sinking fund provisions comprised one "class of equity securities" within the terms of the section.

32. *Cf. Kern County Land Co. v. Occidental Petroleum Corp.*, 411 U.S. 582, 601-02 (1973).

other atypical, extraordinary or unorthodox factual settings as the courts were called upon to apply section 16(b) to various forms of transactions which do not fall within the garden variety cash-for-stock acquisition or disposition of securities. The application of this new thrust of the pragmatic approach which had originated in the conversion area also led courts to find, *inter alia*, that gifts,<sup>33</sup> intracorporate reclassifications,<sup>34</sup> and exchanges of stock between a parent and its wholly owned subsidiary<sup>35</sup> were not to be considered purchases or sales of securities within the reach of 16(b) since in none of these cases was the plaintiff able to show the potential for speculative abuse of inside information.

Along similar lines, a court's determination of the dates of the statutory purchase and/or sale necessarily sheds light on its view of the thrust of 16(b). Most recently, the Second Circuit reaffirmed the earlier view that the statute, by requiring disgorgement of profits resulting from a purchase and sale "within any period less than six months," does not include a closing transaction that occurs exactly six months to the day after the first transaction under scrutiny.<sup>36</sup>

In applying this formula to the non-garden variety transactions, the

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33. *Shaw v. Dreyfus*, 172 F.2d 140 (2d Cir.), *cert. denied*, 337 U.S. 907 (1949); *Lewis v. Adler*, 331 F. Supp. 1258, 1267 (S.D.N.Y. 1971); *Truncate v. Blumberg*, 80 F. Supp. 387 (S.D.N.Y. 1948), *aff'd on other grounds sub nom. Truncate v. Scully*, 182 F.2d 1021 (2d Cir. 1950) (per curiam); *accord*, Proposed Code § 1413(f).

34. *Roberts v. Eaton*, 212 F.2d 82 (2d Cir.), *cert. denied*, 348 U.S. 827 (1954); *accord*, Proposed Code § 1413(h)(2).

35. *Blau v. Mission Corp.*, 212 F.2d 77, 80 (2d Cir.), *cert. denied*, 347 U.S. 1016 (1954), where the court viewed the exchange as "a mere transfer between corporate pockets," with the parent "receiv[ing] in indirect interest [in the issuer] exactly what it gave up in direct interest." *But cf. Blau v. Hodgkinson*, 100 F. Supp. 361 (S.D.N.Y. 1951), where an exchange of stock whereby the insider received stock in the parent corporation in exchange for his holdings in the subsidiary was held to have been a statutory purchase where in lieu of receiving the new stock he could have elected to exercise his dissenter's rights for a cash equivalent.

36. *Colonial Realty Corp. v. MacWilliams*, 512 F.2d 1187 (2d Cir. 1975) (per curiam), *aff'g* 381 F. Supp. 26 (S.D.N.Y. 1974). The court there adopted the following method of computation:

[The defendant] construes the words "period of less than six months" to mean a period the first and last days of which each include the twenty-four hours from midnight to midnight, and the last day of which is the second day prior to the date corresponding numerically to that of the first day of the period in the sixth succeeding month. For example, the period from and including January 1st to and including June 29th would be a "period of less than six months" but the period to and including June 30th would be a period of exactly six months. Thus profit realized from a purchase on January 1st and a sale on June 30th would not be recoverable under the statute.

That construction is correct.

381 F. Supp. at 27, *quoting Stella v. Graham-Paige Motors Corp.*, 132 F. Supp. 100, 103-04 (S.D.N.Y. 1955), *remanded on other grounds*, 232 F.2d 299 (2d Cir.), *cert. denied*, 352 U.S. 831 (1956); *accord*, *Morales v. Reading & Bates Offshore Drilling Co.*, 392 F. Supp. 41, 45 (N.D. Okla. 1975).

courts must still determine the dates upon which the purchase and sale take place within the meaning of section 16(b). Within this context the issue has been framed in terms of the date upon which the purchasers' or sellers' rights and duties "become fixed."<sup>37</sup> For example, where the issuer's board of directors had approved the acquisition of the shares of another corporation from the defendant in exchange for its own stock, with the formal agreement and approval following two months later, the court refused to characterize the original approval as the purchase date since it was "nothing more than an authorization to negotiate" and, more importantly, the defendant did not incur any obligation to acquire—*i.e.* "purchase"—the shares until the formal agreement had been executed.<sup>38</sup> Similarly, where the insider grants to a third party an option to sell the issuer's stock to the insider at a certain price on a fixed date, the optionor's section 16(b) purchase occurs only when and if the option is exercised, rather than on the date it was granted, since the optionor cannot be said to have a fixed obligation until triggered by the optionee's action.<sup>39</sup>

The determination of the dates of purchase and sale may arise in other contexts as well. For example, with respect to an insider who had exercised rights under a stock option but postponed payment for three years, the 16(b) "purchase" was held to have occurred on the date of exercise, since "[t]hereafter for all speculative purposes he owned the stock."<sup>40</sup> Accordingly, profits realized from the optionee's sale of stock within six months after his payment but more than three years after the option's exercise were not recoverable under the section. A similar issue

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37. *Silverman v. Landa*, 306 F.2d 422, 424 (2d Cir. 1962); *Blau v. Ogsbury*, 210 F.2d 426, 427 (2d Cir. 1954).

38. *Champion Home Builders Co. v. Jeffress*, 490 F.2d 611, 614-15, 617 (6th Cir.), *cert. denied*, 416 U.S. 986 (1974).

39. *Silverman v. Landa*, 306 F.2d 422, 424 (2d Cir. 1962); *Lewis v. Realty Equities Corp.*, 373 F. Supp. 829, 831-32 (S.D.N.Y. 1974); *cf.* *Miller v. General Outdoor Advertising Co.*, 337 F.2d 944 (2d Cir. 1964); *but cf.* *Bershad v. McDonough*, 428 F.2d 693 (7th Cir. 1970), *cert. denied*, 400 U.S. 992 (1971). *See also* *Morales v. Reading & Bates Offshore Drilling Co.*, 392 F. Supp. 41, 44 (N.D. Okla. 1975). In *Perfect Photo, Inc. v. Sentiff*, 205 F. Supp. 574 (E.D. Pa. 1962), on October 8, 1954, an employee agreed to purchase ten shares of the issuer's stock; on October 23, the defendant, acting in the optionee's stead, purchased the shares which he sold on April 14, 1960 at a \$536.49 profit. The defendant contended that October 18 was the date of purchase, thereby negating any 16(b) liability; however, the court rejected this argument since it was not until October 23 that the defendant obligated himself as the purchaser. 205 F. Supp. at 575. *See* *Michaely & Lee, Put and Call Options: Criteria for Applicability of Section 16(b) of the Securities Exchange Act of 1934*, 40 NOTRE DAME LAW. 239 (1965); Note, *Put and Call Options Under Section 16 of the Securities Exchange Act*, 69 YALE L.J. 868 (1960).

40. *Blau v. Ogsbury*, 210 F.2d 426, 427 (2d Cir. 1954).

was presented to the First Circuit in *Booth v. Varian Associates*.<sup>41</sup> The defendants entered into an agreement to sell to Varian their holdings in Bomac Laboratories in exchange for that amount of Varian stock which, according to the market price on the day before closing, would equal a sum certain plus a figure based upon Bomac's retained earnings. Within less than six months after the closing but more than six months after the execution of the agreement for exchange of stock, the defendants sold a portion of their Varian stock at a profit which the plaintiff sought to recapture under 16(b). The plaintiff in *Varian Associates* maintained that no purchase had occurred until the exchange took place and the price under the formula had become fixed. The court, after reviewing the option and conversion cases, concluded that those cases involved issues not present in the *Varian* situation and were not "especially helpful;" therefore, the court decided to "resolve the question involved in a manner that is practical and logical and will be most consonant with the statutory purpose."<sup>42</sup> It was then noted that since the purchase price under the agreement was dependent upon market fluctuations and was not established until the closing date, speculation on the contract would be not only "risky," but "virtually impossible." Accordingly, the court held that 16(b) had been violated since the "purchase" occurred at the time of the actual exchange.<sup>43</sup> It follows that, as in the case of options, no purchase can take place until all obligations have been firmly established.<sup>44</sup> This type of analysis, which entails looking beyond the surface of the transactions and considering their substantive nature within the context of section 16(b)'s purpose, has been the backbone of the pragmatic approach.

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41. 334 F.2d 1 (1st Cir. 1964), *cert. denied*, 379 U.S. 961 (1965).

42. *Id.* at 3-4.

43. *Id.* at 4. The defendants contended that on the date of the exchange they were acting on the basis of a pre-existing obligation arising out of the contract and pointed to the section's exemption for securities "acquired in good faith in connection with a debt previously contracted." The court rejected this theory since that statutory exception is limited to "payment of 'independent and matured obligations.'" *Id.* at 5. *See, e.g., Rheem Mfg. Co. v. Rheem*, 295 F.2d 473, 476 (9th Cir. 1961); *Smolowe v. Delendo Corp.*, 136 F.2d 231 (2d Cir.), *cert. denied*, 320 U.S. 751 (1943).

44. *Cf. Kahansky v. Emerson Radio & Phonographic Corp.*, 184 F. Supp. 90 (S.D.N.Y. 1960), in which the defendant Emerson had negotiated an agreement to acquire control of Webcor, Inc., and the shares were duly delivered. Three Webcor directors balked on their agreement to resign from the board. Emerson redelivered the shares in return for \$100,000 above the purchase price and granted a general release and discontinued pending litigation. The court ruled that 16(b) did not permit Webcor to recapture the \$100,000 since there was no "profit realized" as this had been a rescission of the initial transaction with Emerson receiving the premium in settlement of its breach of contract claims. *See also Hennesey v. Fein*, 184 F. Supp. 86 (S.D.N.Y. 1958) (transaction rescinded with judicial approval is not within the purview of 16(b)).

Taking the position that the insider's rights and duties be fixed before a "purchase" occurs, the courts have arrived at the conclusion that no section 16(b) liability will attach if the transactions have been consummated or triggered by virtue of independent intervening events or actions. In other words, the section only applies to the type of situation in which the insider could have utilized his or her access to inside information to *insure* a "sure thing" short-swing profit.

There have been, however, a few scattered instances in which courts have refused to apply the pragmatic approach in atypical fact contexts. For example, the Fifth Circuit refused to engage in subjective analysis within the context of the bizarre factual setting in *Mouldings, Inc. v. Potter*.<sup>45</sup> The defendant Potter, an officer and director of Mouldings, placed with his broker, Bache & Company, an order to sell shares of the corporation's common stock. After the stock had been sold on the exchange, Bache realized that the shares which the defendant had placed for sale were unregistered restricted securities which could not be sold on the open market. As a result Potter's attempted disposition of the shares turned out to be a short sale. Potter, with Bache's assistance, arranged to cover the sale with shares held by a group of the defendant's friends and business associates; in return Potter diverted the "profit" to the members of the group.<sup>46</sup> The plaintiff sought to recapture this short-swing profit. The defendant took the position that, by simply placing the members of the group in his shoes, his dealings resulted in a novation of the original sale. The Fifth Circuit rejected the novation theory since otherwise it would have been giving its sanction to the diversion of an insider's short-swing profits from the issuer to a group designated by the insider, which according to the court would thwart 16(b)'s purpose. The court then rejected the speculative abuse test since the transactions in question had been garden variety cash-for-stock sales and purchases. The Fifth Circuit did not see any "purposeless harshness" in this result since the facts at hand created precisely the type of situation at which the section is aimed.<sup>47</sup> Notwithstanding these occasional departures from

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45. 465 F.2d 1101 (5th Cir. 1972).

46. By this time the market price had fallen and Potter did not wish to subject himself to 16(b) liability by purchasing shares at the lower price in order to cover his short sale. 465 F.2d at 1103-04.

47. *Id.* at 1104, relying on the subjective test as defined in *Blau v. Max Factor & Co.*, 342 F.2d 304 (9th Cir. 1965). Similarly, in *Western Auto Supply Co. v. Gamble-Skogmo, Inc.*, 348 F.2d 736 (8th Cir. 1965), the defendant corporation had transferred some of its recently purchased stock of the issuer to an employee trust fund and then claimed that the shares so transferred could not properly be classified as subject to 16(b): "Gamble-Skogmo elected to become a statutory fiduciary by owning a more

the subjective approach, however, the trend continued to develop and is currently undergoing redefinition under the new pragmatism.

THE EFFECT OF THE MERGER MOVEMENT—  
THE NEW PRAGMATISM

The merger movement of the nineteen sixties and early seventies set the stage for additional 16(b) problems and a new potential for application of the pragmatic trend. It is within this context that the new pragmatism arose. Interestingly, however, the early merger decisions appeared to indicate a retrenchment from the subjective analysis.

For example, in *Marquette Cement Manufacturing Co. v. Andreas*<sup>48</sup> the court was faced with a "Type C" reorganization whereby North American Cement Corporation exchanged all of its assets in return for a substantial portion of the stock of the plaintiff Marquette. Andreas, the individual defendant, and the defendant Andreas Corporation had owned a large block of North American stock. Andreas was a statutory insider by virtue of his position as chairman of the North American's board of directors. At the time that the merger was approved, Andreas was elected to Marquette's board. After the stock-for-asset exchange had taken place, North American dissolved, distributing the Marquette stock to the former North American shareholders, and the defendants sold their Marquette stock on the open market within less than six months of their receipt of the shares. The defendants argued that there had been no statutory purchase, drawing an analogy to the "no purchase" approach which had been taken towards an intracorporate reclassification.<sup>49</sup> The district court rejected this contention, reasoning that the transaction was more akin to the garden variety cash-for-stock purchase than to the unorthodox transaction in which the courts will require a showing of the potential for the abuse of inside information as a condition precedent to calling 16(b)'s remedial sanctions into play.<sup>50</sup>

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than 10% interest in Western Missouri stock. Its voluntary assumption of loyalty subjects it to the disciplinary effect of § 16(b), regardless of the legitimate purpose for which the shares were destined." *Id.* at 742.

48. 239 F. Supp. 962 (S.D.N.Y. 1965).

49. *See Roberts v. Eaton*, 212 F.2d 82 (2d Cir. 1954).

50. The court said:

This is not a case where the stock of all shareholders is reclassified with some guarantee of equal treatment for all, but rather a case where a block of stock is acquired by a separate interest group at a price negotiated by them. Nor is this a case where the defendants retain the same interest in the plaintiff corporation before and after the transaction. Originally, the Corporation held North American stock—after the transaction it held the stock of Marquette.

The expansion of subjectivism under the pragmatic approach, as well as its extension into the new pragmatism, appeared to be further retarded by the Supreme Court's 1972 decision in *Reliance Electric Co. v. Emerson Electric Co.*<sup>51</sup> Emerson Electric attempted to acquire control of Dodge Manufacturing Company by means of a cash tender offer. But its efforts to acquire control were subsequently thwarted when the Dodge management responded by entering into a defensive merger with the plaintiff, Reliance Electric. Since Emerson had acquired its interest in Dodge with an eye towards control rather than as an investment position, it was necessarily in the defendant's best interest to dispose of its holdings as quickly as possible. Accordingly, Emerson sold a portion of its holdings in Dodge which reduced Emerson to a less than ten percent owner. Subsequently, but still within six months of the initial purchase, Emerson sold the remainder. Before the Supreme Court, Emerson maintained that section 16(b) could not be applied to the second sale since, with its holdings having been reduced to 9.96 percent, it was no longer a statutory insider. The Court, through Justice Stewart, held that the statute's requirement that the ten percent owner be such *both* "at the time of the purchase and of the sale" vindicated Emerson's position.<sup>52</sup>

Justice Douglas, in dissent, accused the Court of employing the objective approach to undermine what he viewed as the clear thrust of section 16(b):<sup>53</sup>

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The acquisition here cannot be thought of as comparable to an involuntary conversion. . . .

. . . The present case, where the assets of a corporation are exchanged for stock and that stock distributed to stockholders, more closely resembles the ordinary Section 16(b) transaction where stock is bought for cash than it does the unorthodox reclassification, consolidation cases where the courts have had to go far to find a purchase. In *Stella v. Graham-Paige Motors Corporation*, 132 F. Supp. 100 (S.D.N.Y. 1955) Judge Dimock held an exchange of the assets of one company for the stock of another to be a "purchase" within the meaning of the statute.

239 F. Supp. at 966. See also, e.g., *Mueller v. Korholz*, 449 F.2d 82 (7th Cir. 1971); *Newmark v. RKO General, Inc.*, 425 F.2d 348 (2d Cir.), cert. denied, 400 U.S. 854 (1970). In contrast, it has been suggested that mergers not be subjectively scrutinized and that the courts should revert to the *Park & Tilford* approach since "perhaps more than any other transactions, [they] are fraught with the possibility of insider abuse." Hemmer, *Insider Liability for Short-Swing Profits Pursuant to Merger and Related Transactions*, 22 VAND. L. REV. 1101, 1115 (1969).

51. 404 U.S. 418 (1972).

52. *Id.* at 422-24; see note 54 *infra*. The other side of this issue, whether "at the time of" requires that a ten percent owner have such status *prior* to the purchase in question, is discussed at text accompanying notes 147-96 *infra*.

53. 404 U.S. at 431 (Douglas, J., dissenting). It is interesting to note that this "objective" decision was contained in Justice Stewart's opinion, while fifteen years earlier he authored what has since been heralded as the decision which formed the basis of the



[T]he 10% rule is based upon a conclusive statutory presumption that ownership of this quantity of stock suffices to provide access to inside information. *Newmark v. RKO General, Inc.*, 425 F.2d 348 (CA2). The rationale of the six-month rule implies that such information will be presumed to be useful during that length of time. It follows that all sales by a more-than-10% owner within the six-month period carry the presumption of a taint, even if a prior transaction within the period has reduced the beneficial ownership to 10% or below.<sup>54</sup>

Douglas's position is not without merit and should not be taken lightly since the Court's holding on its face appears to create a substantial loophole in the Act.<sup>55</sup> On the other hand, Stewart could have reached the same result on the facts by pragmatically scrutinizing the transaction in terms of the potential for abuse of inside information. Although Emerson was more than a ten percent owner, it clearly was not an insider as that term is generally understood. It did not have sufficient control of Dodge to prevent the defensive merger and thus presumably was not privy to confidential information. In fact, one year later the Court, in *Kern County Land Co. v. Occidental Petroleum Corp.*,<sup>56</sup> considered this rationale in applying the speculative abuse test to avoid a finding of 16(b) liability.

In *Kern County* the Court was faced with a somewhat similar fact setting.<sup>57</sup> As had been the case in *Reliance Electric*, the management of the target company opposed the takeover and reacted with a defensive

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pragmatic trend. See *Ferraiolo v. Newman*, 259 F.2d 342 (6th Cir. 1958), cert. denied, 359 U.S. 927 (1959), discussed in text accompanying notes 24-25 *supra*. Justice Stewart is not alone in this apparent inconsistency, see text accompanying notes 64-67 *infra*. See generally Note, *Reliance Electric and 16(b) Litigation: A Return to the Objective Approach?*, 58 VA. L. REV. 907 (1972).

54. 404 U.S. at 442 (Douglas, J., dissenting). Stewart responded to this objection as follows: "While there may be logic in this position, it was clearly rejected as a basis for liability when Congress included the proviso that a 10% owner must be such both at the time of the purchase and of the sale." *Id.* at 424. The ALI, while approving Stewart's analysis under a literal reading of the present section, would overrule the decision and side with Douglas's position. Proposed Code § 1413(d)(2), Comment 6(b).

55. See text accompanying notes 177-78 *infra*.

56. 411 U.S. 582 (1973). See, e.g., Comment, *Securities Laws—Non-Cash Exchange Pursuant to a Defensive Merger Held Not a Purchase or Sale Under Section 16(b) of the Securities Exchange Act of 1934—Kern County Land Co. v. Occidental Petroleum Corp.*, 49 N.Y.U.L. REV. 353 (1974); Comment, *Reliance Electric, Occidental Petroleum, and Section 16(b): Interpretive Quandary over Mergers*, 51 TEXAS L. REV. 89 (1972).

57. Occidental Petroleum, after unsuccessful merger negotiations with Old Kern's management, announced on May 8, 1967, a cash tender offer to purchase 500,000 shares of the latter's common stock which comprised more than ten percent of the outstanding shares in that class. On May 11, Occidental extended its offer to cover an additional 500,000 shares. 411 U.S. at 584-85.

merger. Within two weeks Kern announced its approval of a stock-for-stock merger with Tenneco Corporation. The exchange left Occidental in the same position as Emerson Electric; but, rather than sell its holdings piecemeal as had been done in the *Reliance* case, Occidental arrived at an arrangement with Tenneco whereby the latter could repurchase its shares from Occidental. Under an agreement entered into with Tenneco two weeks after approval of the merger, Occidental issued to Tenneco an option to purchase the Tenneco preferred shares in six months at 105 dollars per share in return for Tenneco's paying Occidental a premium of ten dollars per option which would be applied to the exercise price. More than six months after both Occidental's purchase of the Old Kern stock and its acquisition via the exchange of the Tenneco stock, Tenneco exercised the option.

The plaintiff, asserting that Occidental be required to disgorge its short-swing profits, moved for summary judgment and prevailed in the district court, which held that Occidental's acquisition of Tenneco stock pursuant to the Old Kern-Tenneco merger was a section 16(b) "sale" within six months of its purchases pursuant to the original tender offer and further that the subsequent option agreement was a second "sale", also within the reach of section 16(b).<sup>58</sup> On appeal, the Second Circuit reversed, reasoning that the exchange pursuant to the merger could not properly be classified as a 16(b) sale since there had been no potential for speculative abuse. It also rejected the alternative of classifying the option agreement as a "sale" since Occidental's obligation to dispose of the shares had not been fixed until Tenneco exercised the option more than six months later.<sup>59</sup>

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58. *Abrams v. Occidental Petroleum Corp.*, 323 F. Supp. 570, 579-80 (S.D.N.Y. 1970).

59. It is urged that Occidental possessed the "inside information" that Old Kern might well respond [to its takeover attempt] by arranging a "defensive merger" and that, if the terms were sufficiently favorable, Occidental would not try to top them. But, in contrast to [*Newmark v. RKO General, Inc.*, 425 F.2d 348 (2d Cir.), *cert. denied*, 400 U.S. 854 (1970)] where the buyer knew of the imminent announcement of a merger that would enhance the price of the shares and could largely control its course, Occidental had no knowledge what Old Kern would do, and certainly did not know that Old Kern would be able to arrange an exchange offer exceeding Occidental's bid by \$20 per share, with the added benefit of freedom from capital gains tax. We fail to see the possibility of speculative abuse in a situation where such an offeror simply declines to make a still higher offer or to attempt a block transaction which it regards as advantageous to all the stockholders including itself.

*Abrams v. Occidental Petroleum Corp.*, 450 F.2d 157, 163 (2d Cir. 1971) (footnotes omitted). In the *Newmark* case RKO controlled Frontier Airlines which was contemplating a merger with Central Airlines. During the course of the merger negotiations RKO independently acquired an option to purchase forty-nine percent of Central's common stock. RKO exercised the option and realized a short-swing profit when the Frontier-Central merger was consummated. 425 F.2d at 353.

The Supreme Court, speaking through Justice White, resurrected the pragmatic trend (which was thought to have been severely restricted, if not put to rest, in the Court's apparent return to objectivism in *Reliance Electric*) when it announced:

In deciding whether borderline [unorthodox] transactions are within the reach of the statute, the courts have come to inquire whether the transaction may serve as a vehicle for the evil which Congress sought to prevent—the realization of short-swing profits based upon access to inside information—thereby endeavoring to implement congressional objectives without extending the reach of the statute beyond its intended limits.<sup>60</sup>

In applying this standard, the Court followed Judge Friendly's approach below in holding that the exchange of Old Kern stock for the Tenneco preferred was not a statutory sale.<sup>61</sup> Additionally, the Court characterized Occidental's position at the time that the Old Kern-Tenneco merger had been announced as treading water between Scylla and Charybdis, in that the only realistic alternative to participating in the exchange and subsequent sale to Tenneco would have been to dispose of the Old Kern stock on the open market via a garden variety cash-for-stock sale which would have resulted in certain 16(b) liability. The Court neglected to point out, however, that Occidental could have at least limited its liability had it chosen to utilize the two-step sale of the *Reliance* type. Perhaps by not mentioning this alternative the Court was *sub silentio* questioning its previous decision on this point.

Proceeding on the theory that there had not been a statutory sale by virtue of the exchange, the next question for decision was whether Occidental "sold" its new Tenneco shares on the date of the option agreement or at the time it was exercised. The plaintiff's theory was to predicate liability upon Occidental's disposition of its Tenneco holdings as of June 2—the date of execution of the option agreement—rather than looking to the date of Tenneco's exercise which was beyond the six-month statutory period. This view had been previously rejected by other courts with regard to the analogous question of whether an option agreement constitutes a 16(b) "purchase" prior to its exercise.<sup>62</sup> The Court in *Kern County* reasoned that Occidental's obligation to dispose

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60. 411 U.S. at 595-96 (footnote omitted). The Court acknowledged some continued adherence to the objective approach of *Park & Tilford* and *Heli-Coil* (see text accompanying notes 22-27 *supra*) but concluded that "[b]y far the greater weight of authority is to the effect that a 'pragmatic' approach to § 16(b) will best serve the statutory goals," *id.* at 594 n.26.

61. *Id.* at 596-97.

62. See text accompanying note 39 *supra* and cases cited therein.

of the stock did not become fixed until Tenneco's exercise on December 11. The Court also pointed out that as of June 2, Occidental had not insured itself of a profit since, had the stock price declined sufficiently in value by the exercise date, the defendant would have been left with Tenneco holdings worth less than the "purchase" price, notwithstanding the option premium.<sup>63</sup>

Justice Douglas, joined by Justices Stewart and Brennan, dissented from the Court's affirmance on the grounds that the Old Kern-Tenneco exchange pursuant to the merger was a statutory sale since Occidental's "status as a shareholder of Old Kern terminated" for value.<sup>64</sup> The line-up of the justices in *Kern County* presents an interesting reversal of their theoretical positions which can only add to the confusion of 16(b) jurisprudence. Justice Douglas, who had vigorously opposed the objective approach taken one year earlier in *Reliance Electric*, was now put in the position of denouncing the pragmatic view taken by the majority in *Kern County*:

It is true that in some cases an insider may be required to disgorge profits even though his transactions do not lend themselves to the abuses that underlay the enactment of § 16(b). The draftsmen carefully weighed this eventuality and opted for a bright-line rule. As Thomas Corcoran stated: "You have to have a general rule. In particular transactions it might work a hardship, but those transactions that are a hardship represent the sacrifice to the necessity of having a general rule."<sup>65</sup>

Conversely, Justice Stewart, who was one of the earliest proponents of a pragmatic approach in *Ferraiolo v. Newman*,<sup>66</sup> apparently reversed his position in his opinion in *Reliance Electric* opting for objectivism, and he reaffirmed his adherence to the objective approach by joining with Justice Douglas in *Kern County*. Justice Blackmun, on the other hand, who as a circuit judge had favored the objective approach,<sup>67</sup> joined with the majority in *Kern County*. These shifts in position are more than

63. 411 U.S. at 602.

64. *Id.* at 607 (Douglas, J., dissenting). Apparently Douglas would only employ the subjective approach if it would result in 16(b) liability as in *Reliance* rather than removing the insider from the statute's grasp.

65. *Id.* at 610.

66. 259 F.2d 342 (6th Cir. 1958), *cert. denied*, 359 U.S. 927 (1959). See text accompanying notes 24-25 *supra*.

67. My own reaction is that either the statute means what it literally says or that it does not; that if the Congress intended to provide additional exceptions, it would have done so in clear language; and that the recognized purpose and aim of the statute are more consistently and protectively to be served if the statute is construed literally and objectively rather than non-literally and subjectively on a case-by-case application. The latter inevitably is a weakening process.

*Petteys v. Butler*, 367 F.2d 528, 538 (8th Cir. 1966) (Blackmun, J., dissenting).

mere academic curiosities since the Supreme Court has again been called upon to clarify the applicability of section 16(b) to the unorthodox corporate consolidation.<sup>68</sup> Unfortunately, the lower court decisions which have been announced in the wake of *Kern County* have only added to the confusion by their lack of consistency in the application of this new pragmatism.

The other side of the *Kern County* coin was at issue in *Gold v. Sloan*,<sup>69</sup> in which the Fourth Circuit was asked to decide whether an exchange of stock pursuant to a merger between the Atlantic Research and Susquehanna corporations constituted a "purchase" under 16(b).<sup>70</sup> Within less than six months after the merger had been consummated the defendant insiders sold their newly acquired Susquehanna holdings at a profit. The Fourth Circuit pointed to the Supreme Court's decision in *Kern County* as having "resolved [the] conflict and adopted what had earlier been described as a 'pragmatic rather than technical' test."<sup>71</sup> In applying this *ad hoc* test, the court deemed it necessary "to examine the particular situation of each defendant as it relates to the merger."<sup>72</sup>

Three of the defendants in *Gold* had no contact whatsoever with the merger negotiations and thus were held to have had no access to Susquehanna's inside information. In contrast, the fourth defendant, Arthur Sloan, Atlantic's chief executive officer had been "in complete charge of the negotiations" and "had access to the books and records of Susquehanna during this period" which in the eyes of the court created the possibility of abuse.<sup>73</sup> This bifurcated analysis led to the "somewhat paradoxical, but unavoidable" conclusion that as to Arthur Sloan the merger constituted a "purchase" of the Susquehanna shares, whereas there had been no statutory purchase, and thus no section 16(b)

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68. *Provident Sec. Co. v. Foremost-McKesson, Inc.*, 506 F.2d 601 (9th Cir. 1974), *cert. granted*, 420 U.S. 923 (1975). See text accompanying notes 86-91, 181-190 *infra*.

69. 486 F.2d 340 (4th Cir. 1973), *cert. denied*, 419 U.S. 873 (1974). See, e.g., Note, *Securities Exchange Act Section 16(b): Fourth Circuit Harvests Some Kernels of Gold*, 42 *FORDHAM L. REV.* 852 (1974); *Recent Developments, Securities—Section 16(b)—Mergers as a "Purchase,"* 20 *WAYNE L. REV.* 1415 (1974).

70. Atlantic Research Corporation had merged into the Susquehanna Corporation via an exchange of stock; the defendants in *Gold* had been holders of Atlantic stock for more than six months prior to the merger negotiations, thus eliminating the problem of whether the exchange was a section 16(b) "sale," which had been dealt with in the *Kern County* decision. The defendants were also officers and directors of Atlantic and under the terms of the merger agreement occupied similar positions with respect to Susquehanna, the surviving corporation.

71. 486 F.2d at 343.

72. *Id.* at 344.

73. *Id.* at 351-52.

liability, on the part of the other insiders.<sup>74</sup>

Judge Winter took issue with the majority's treatment of *Kern County* on the ground that there the Court had been presented with an unorthodox "sale" or closing transaction while here the question was the unorthodoxy of the alleged "purchase." He further maintained that the *Gold* majority was incorrect in limiting the scope of its pragmatic inquiry to the possibility of speculative abuse "prior to" the merger while taking the position that any postmerger access to inside information would be "irrelevant" under the *Kern County* test.<sup>75</sup> Winter also pointed out that any such prior access to Susquehanna's books and records could not correctly be presumed to have been obtained by reason of the defendants' "relationship to the issuer"—Susquehanna—since they did not occupy an official position with the surviving corporation until after the merger had been closed. The Fourth Circuit thus took the position that the inside information must be presumed to have been obtained before both the section 16(b) "purchase" and "sale."<sup>76</sup>

While the Fourth Circuit majority was certainly correct in reasoning that one who negotiates a merger will have access to the other corporation's books, its analysis would be better geared to a rule 10b-5 action since section 16(b) by its terms is addressed to the relatively narrow situation in which such access is presumed solely on the basis of being a statutory insider. It does not apply to all persons who might have ingress to a corporation's inner workings by reason of his or her holding some other position. In his opinion dissenting from the court's denial of *Gold's* motion for an en banc rehearing, Chief Judge Haynsworth would have absolved all four defendants on similar grounds, since in a merger situation one who thereby becomes an officer or director has a "position as an insider [which] is more technical than substantive."<sup>77</sup> The *Gold*

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74. *Id.* at 352. See also *Morales v. Arlen Realty & Dev. Corp.*, 352 F. Supp. 941, 944-45 (S.D.N.Y. 1973) (similar distinction).

75. 486 F.2d at 354 (Winter, J., concurring in part and dissenting in part).

76. *Cf. Provident Sec. Co. v. Foremost-McKesson, Inc.*, 506 F.2d 601, 607-15 (9th Cir. 1974), cert. granted, 420 U.S. 923 (1975); see text accompanying notes 147-96 *infra*.

77. 491 F.2d 729, 731 (4th Cir. 1974). Haynsworth made the point that Atlantic's and Susquehanna's full and honest compliance with the SEC's disclosure requirements had ensured that "all relevant information be disclosed to all stockholders" and thus there could not have been any "relevant inside information [in] the exclusive possession of the insider":

In the usual merger situation, therefore, there is simply no potential for abuse by insiders of the sort contemplated by § 16(b). Unless the insider has done something to alter his position relative to other stockholders, no such exchange ought to terminate an old holding period and start a new one running. When the insider's advantage, derived from the exchange, does not differ in kind or

situation thus raises several questions which the Supreme Court left unanswered in *Kern County*, the most striking of which is whether the Court anticipated that its decision would be used as the basis for the somewhat incongruous result of treating the same transaction as a section 16(b) "purchase" for some insiders but not for others.

In *American Standard, Inc. v. Crane Co.*<sup>78</sup> the Second Circuit was faced with what might be termed as "*Kern County* and *Gold* revisited." Crane had engaged in substantial open market purchases of Air Brake Company stock with an eye towards merger. After the merger negotiations had been terminated by Air Brake's refusal of Crane's offer, Crane resumed its open market activities, acquiring more than ten percent ownership. On January 26, 1968, Air Brake countered Crane's efforts by arranging for a defensive merger with American Standard, Crane's largest competitor. In April and May, Crane purchased additional shares pursuant to a tender offer and three extensions thereof. On May 16 Air Brake shareholders approved the merger with American Standard which was effective on June 7. By June 13, pursuant to the terms of the merger, Crane had exchanged its Air Brake holdings for a large block of American Standard convertible preferred stock which it sold on that date for ten million dollars over what it had paid for the Air Brake shares. The plaintiff proposed three alternative theories for finding Crane liable under section 16(b): a) by matching Crane's "purchases" of Air Brake with the "sale" via the exchange agreement; b) by matching the exchange (*i.e.* purchase) with its sale of American Standard stock, similar to the *Gold* situation, and c) by looking to the defendant's purchase of the Air Brake shares and sale of the American Standard shares.

With regard to the plaintiff's first theory, the court relied on *Kern County* and found itself compelled to rule that the exchange pursuant to the merger was not a "sale" under section 16(b) since the record in the court below contained neither evidence nor allegations that Crane had access to inside information relating to either Air Brake or American Standard or to their plans to consolidate. Judge Gurfein, speaking for the court, dealt with the second theory of liability by reasoning that after having held that the exchange was not a statutory sale, "[i]t would be

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quality from that realized by every other stockholder, there is simply no reason for creating a new holding period for the insider. Starting and stopping holding periods for the insider when he does something which alters his relative position with other stockholders is appropriate; it is not when he has not.

*Id.* (footnotes omitted).

78. 510 F.2d 1043 (2d Cir. 1974).

anomalous, for the same reasons, to hold the identical transaction a 'purchase' . . . ."<sup>79</sup> The court distinguished the *Gold* case on its facts, reasoning that in that case the defendant had the same type of access to advance inside information as had been present in *Newmark v. RKO General, Inc.*<sup>80</sup> where the parent of the merged corporation had purchased shares of the acquiring corporation after negotiations had begun but prior to the final merger agreement. The court also pointed out that in a vigorous takeover battle, like that in *American Standard*, the defeated tender offeror would be locked in for six months and that this result "would act as [an unjustifiable] powerful deterrent on tender offers."<sup>81</sup>

The court in *American Standard* then turned to the plaintiff's third theory, which had been adopted by the lower court in a decision of "first impression" wherein it matched the "purchases of the shares of one 'issuer' against the sale of shares of another 'issuer.'"<sup>82</sup> Judge Gurfein referred to the language of the section which was drafted and enacted in terms of "the issuer," reasoning that it would be overreaching to read it in the plural as the district court had done. Somewhat ironically, here the Second Circuit departed from its earlier adherence to the pragmatic approach in favor of an objective adherence to the literal wording of the statute, reasoning that all of the so-called subjective decisions had involved the matching of an unorthodox transaction in one security against a purchase or sale of the same security.<sup>83</sup> This then raises another issue—when is the *Kern County* approach applicable?<sup>84</sup>

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79. *Id.* at 1056. In so reasoning the court was rejecting Judge Winter's contention in *Gold* that the *Kern* rule is to be applied differently to stock acquisitions and dispositions.

80. 425 F.2d 348 (2d Cir.), *cert. denied*, 400 U.S. 854 (1970), discussed in note 59 *supra*.

81. 510 F.2d at 1057.

82. *Id.*

83. *Id.* at 1060. The drafters of the ALI's Federal Securities Code anticipated this problem but reached the contrary result. Under the proposed legislation the section applies to securities of different issuers which are, *inter alia*, exchanged pursuant to a merger "unless the defendant proves that under the circumstances his purchase and sale (or sale and purchase) could not have lent themselves to speculative abuse." Proposed Code § 1413(g). The drafters go on to exempt anyone who is not an officer or director of either issuer and does not have more than a ten percent interest in the surviving corporation "immediately before his sale," *id.* § 1413(h)(2); but this was not the situation which was before the Second Circuit in *American Standard*.

84. The Second Circuit had previously answered the question as follows: "The courts, however, are free to adopt such a flexible approach in construing § 16(b) only in those cases where the relevant provision is either intrinsically ambiguous or in which there are alternative plausible applications of the provision to a particular factual situation." *Lewis v. Varnes*, 505 F.2d 785, 789 (2d Cir. 1974), *citing Kern County Land Co. v. Occidental Petroleum Corp.*, 411 U.S. 582, 594 (1973). This answer does not leave much room for the objective approach. *See* note 89 *infra*.



The Supreme Court will have the opportunity to answer this and several other open questions in *Provident Securities Co. v. Foremost-McKesson, Inc.*<sup>85</sup> Provident Securities, a personal holding company, decided to liquidate. Under the guidance of an investment adviser who had arranged for a two-step liquidation, Foremost entered into an agreement by which it would acquire a large portion of Provident's assets in exchange for the former's convertible debentures which, within less than six months, were to be sold on the open market pursuant to a registered public offering. Since the Foremost debentures were convertible into more than ten percent of the underlying equity securities, the Ninth Circuit held that Provident was an insider within the terms of 16(b). Although Provident's plan "seemed to be a clear case of Section 16(b) liability,"<sup>86</sup> both the district and circuit courts ruled in the defendant's favor.

The district court analyzed the applicability of section 16(b) in terms of the subjective approach. The court was impressed by Provident's "all-but-momentary status as an 'insider' of Foremost"<sup>87</sup> and noted the absence of allegations that there had been the potential for speculative abuse; from this Judge Schnacke eloquently concluded that liability here could be predicated only on "an extremely crude rule of a most deformed and misshapen thumb."<sup>88</sup> Although the Ninth Circuit affirmed the judgment for Provident, it did not believe that it was creating any such deformity by classifying the transactions in question as subject to the Act, and in doing so found the *Kern County* case inapposite since there was unorthodoxy in the nature of Occidental's transaction which was not present in *Provident*.<sup>89</sup> The court of appeals

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85. 506 F.2d 601 (9th Cir. 1974), *cert. granted*, 420 U.S. 923 (1975), *aff'g* 331 F. Supp. 787 (N.D. Cal. 1971).

86. R. JENNINGS & H. MARSH, JR., *SECURITIES REGULATION: CASES AND MATERIALS* 1244-45 n.2 (3d ed. 1972).

87. 331 F. Supp. at 791. Under the terms of the purchase agreement executed by Foremost and Provident on September 25, 1969, at the closing on October 15, Foremost was to receive two-thirds of Provident's assets in return for cash and the Foremost convertibles which had been issued solely for this purpose. The agreement also provided that Provident would be dissolved and that Provident and its shareholders would organize a registered secondary offering of the debentures. On October 21, the underwriting agreement was executed and the registration statement became effective with the sale to the public taking place on October 28. *Id.* at 790.

88. *Id.* at 792.

89. The only distinction between this transaction and the usual cash-for-stock sale is the nature of the consideration. . . . We see no meaningful distinction between consideration in the form of cash and consideration in the form of a corporate asset. Consequently, as was implicit in *Kern County*, the actual-potential-for-abuse threshold test is not relevant to our determination since that potential is presumed if the elements of the section are satisfied.

506 F.2d at 605; *accord*, *Schur v. Salzman*, 365 F. Supp. 725, 728-30 (S.D.N.Y. 1973).

went on to indicate that even assuming *arguendo* that the speculative abuse test were applicable, 16(b) liability would still exist. This conclusion was reached by distinguishing *Kern County* since the Old Kern and Tenneco managements were hostile to Occidental, therefore making it clear that no access to inside information concerning the merger existed, while "Provident conferred intimately with the Foremost management." Therefore, the Ninth Circuit, taking an approach similar to that of the Fourth Circuit in *Gold v. Sloan*, saw the potential for speculative abuse in this intercorporate intimacy which gave Provident access to Foremost information during the course of the negotiations.<sup>90</sup>

Another important consideration in *Kern County*, which was also present in the *American Standard* case, was the "involuntariness" of Occidental's disposition of its Old Kern and Tenneco shares—lest the unsuccessful tender offeror be left holding the bag. Here, however, Provident's exchange and subsequent sale were not only purely voluntary, they were entered into with an awareness of the potential of their calling into play the sanctions of section 16(b). Notwithstanding the Ninth Circuit's finding that both a purchase and sale had occurred, it affirmed the judgment in Provident's favor on the ground that it had not been a statutory insider prior to the initial purchase.<sup>91</sup> In light of the alternative and conflicting grounds for decision in the lower courts, it remains open to speculation whether the Supreme Court will find it necessary to clarify many of these issues which have been raised in the post-*Kern County* era.

The American Law Institute's proposed legislation acknowledges that in the merger situation, in which an insider participates in an exchange of stock on the same footing as other shareholders, application of strict liability principles could easily result in unnecessary harshness as evidenced by the cases just discussed. Accordingly, the drafters would codify a variation of the new pragmatism by exempting from its short-swing inhibitions transactions pursuant to the exercise of conversion

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90. For example, assume Provident learned that Foremost had decided not to declare a dividend in order to maintain the capital it would need to develop the real estate just acquired from Provident. On the basis of this information, Provident might have reasoned that the market value of Foremost stock would rise in response to the news of the acquisition and then fall in response to the news of the decision not to declare a dividend. Provident might have concluded that it should sell its stock just after the acquisition news, but just before the dividend news, became public. Such trading is exactly the kind of speculative abuse that section 16(b) is designed to discourage. Thus, even if we assume that the Provident-Foremost transaction was unorthodox, we are required to subject it to section 16(b) scrutiny.

506 F.2d at 606.

91. This aspect of the Ninth Circuit's opinion is discussed in the text accompanying notes 180-90 *infra*.

rights, mergers and other forms of corporate reorganizations "if the defendant proves that he did not use information obtained by reason of his relationship to [the] issuer."<sup>92</sup> With this formulation the outcome of a particular case could differ from that which would result from application of the test which has been emerging in the most recent cases. Under the approach adopted by the *Kern County, Gold, Provident Securities* and *American Standard* decisions, courts will not impose section 16(b)'s sanctions unless it has been shown that there existed a *possibility* of speculative abuse, regardless of whether the defendant did in fact rely upon inside information. However, under the Proposed Code, the innocent defendant would be absolved of liability. While in this respect the code would seem to place the defendant in a more favorable position, he or she would be at a disadvantage insofar as the plaintiff would not have the burden of proving that the potential existed. Although the drafters' comments are silent on this point, it is possible that if the defendant shows that there was in fact no such potential, then he or she could be considered to have satisfied the Proposed Act's burden by virtue of circumstantial evidence.<sup>93</sup>

The ramifications of the *Kern County* method of subjective scrutiny have also been extended into cases in which courts have analyzed the concepts of purchase and sale other than within the context of transactions pursuant to intercorporate reorganizations.<sup>94</sup> For example, in *Morales v. Mapco, Inc.*<sup>95</sup> the defendant had over a period of seven years purchased 3,616 Mapco warrants which expired on April 1, 1972; in addition he already owned some of the company's common stock. Each warrant, at the holder's election, was automatically convertible into one half of a share of Mapco common on April 1, 1972; or, alternatively, if exercised with a payment of nine dollars per option, was convertible into one full share. The warrants contained an antidilution provision which protected the holder against the issuance of additional common at less than eighteen dollars per share. Between February 29 and March 23,

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92. Proposed Code § 1413(h)(1).

93. Section 1413(g) gives the defendant the burden of proving the absence of the possibility of abuse as compared with subsection (h)(1)'s focus on the absence of actual abuse, *see* note 83 *supra*. Compare Proposed Code § 1413, Comment 12(c), with *id.*, Comment 13(a).

94. For example, in *Perrine v. William Norton & Co.*, 509 F.2d 114 (2d Cir. 1974), the court drew from the Supreme Court's subjective approach in looking beyond the literal reading of rule 16b-2's (17 C.F.R. § 240.16b-2 (1974)) exemption for certain transactions in the course of a public offering. *Cf.* *Brenner v. Career Academy, Inc.*, 467 F.2d 1080 (7th Cir. 1972); Proposed Code § 1413(h)(6).

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

1972, while serving as the company's financial vice-president, defendant sold 900 shares of common stock and exercised 1,100 warrants by "submitt[ing] \$9.00 plus one warrant to his broker . . . . The common stock was then sold and the proceeds applied to the Ross account."<sup>96</sup> The court concluded that this was not the "traditional 'cash-for-stock' purchase" and proceeded to apply the pragmatic test under the *Kern County* guidelines. Since the warrants were automatically convertible and contained the antidilution clause, they were considered to have been the "economic equivalent" of the underlying common.<sup>97</sup> Furthermore, as of March 31, more than ninety-eight percent of the issuer's outstanding warrants had been exercised pursuant to the one-for-one alternative in order to avoid the economic loss which would otherwise have resulted from the automatic conversion. The court viewed this as indicative of the practical absence of voluntariness in defendant's exercise of the warrants. A third factor which led the court to grant defendant's motion for summary judgment was the simultaneous nature of the exercise and subsequent sale of common thus giving no opportunity for abuse between the two transactions. The court also noted that since the stock continued to rise in price, Ross would have realized a greater profit had he held on to the stock. While this fact might indicate the absence of *actual* abuse and would be relevant under the Proposed Code, it does not bear upon the key question under the present test which is framed in terms of the *possibility* of abuse.

The first two factors which were considered by the *Mapco* court are together sufficient to warrant a finding of no liability. However, the injection of the simultaneous nature of the exercise and sale as an alternative ground for decision appears to be off the mark. Since defendant Ross had been an insider prior to the exercise of the warrants, he was in a position in which access to information is generally presumed. It is quite conceivable that someone in this position could, prior to his or her acquisition of the stock, gain access to information which when publicly released would cause a decline in market price. In such a case, assuming that the exercise of the warrants were to be classified as a purchase rather than being treated similarly to a conversion, the immediate sale of the common would then be predicated upon the type of speculative abuse at which the statute is directed.

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96. *Id.* at 97,878. On March 24, Ross exercised the remaining 2,516 warrants. *Id.* at 97,877.

97. *Id.* at 97,879. This situation is comparable to the cases where the defendant exercised his conversion rights in order to avoid the redemption of his preferred stock. See text accompanying notes 25-28 *supra*.

The sort of simultaneous purchase and sale in *Mapco* is quite distinct from the arbitrage transaction, which is expressly exempt from the section's coverage,<sup>98</sup> where there clearly is no opportunity for abuse. The leading case on section 16(e)'s exemption for arbitrage transactions is *Falco v. Donner Foundation*,<sup>99</sup> which, although not generally cited as such, may have been the first 16(b) case to employ a subjective approach to the statute. The defendant owned more than ten percent of Pittsburgh Steel's preferred stock. The company was in arrears of its dividends by \$50.625 per share. On January 8, 1951, Pittsburgh announced a twenty-five dollar dividend for shareholders of record on January 19. On the record date, the defendant, for tax reasons and other financial considerations, sold two thousand shares with the right to the dividend payments and simultaneously purchased the same amount ex-dividend. On February 2, Pittsburgh declared a second special dividend and on the record date the defendant repeated its simultaneous transactions to the tune of eleven thousand shares. As a result it realized a "profit" which the plaintiff claimed should inure to Pittsburgh under 16(b). The defendant pointed to 16(e)'s "arbitrage" exemption, and the issue before the court was whether its simultaneous record date transactions fell within the subsection. Nowhere in the securities acts, nor in the SEC's rules, is the term "arbitrage" defined. The court concluded that although the simultaneous nature of the purchase and sale is an earmark of arbitrage, the transactions in question did not fall precisely within the ordinary usage of the term.<sup>100</sup> While the objective approach might have led the court to end its analysis here and rule in the plaintiff's favor, it looked beyond the statute's face and concluded that the transactions at issue were not within the scope of 16(b):

The arbitrager's position in the issuer's security remains unchanged throughout his dealings. The transactions are based on knowledge of existing prices and hence devoid of any speculative element. Insider profits by their nature depend on public reaction over a mea-

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98. Section 16(e), 15 U.S.C. § 78p(e) (1970); cf. Proposed Code § 1413(h)(5).

99. 208 F.2d 600 (2d Cir. 1953). Prior to 1964, section 16(e) had been section 16(d), see Act of Aug. 20, 1964, Pub. L. No. 88-467, § 8(b), 78 Stat. 579 (1964).

100. There are three basic forms of arbitrage transactions—1) time arbitrage: where one simultaneously matches the purchase of a commodity with a sale for future delivery; 2) space arbitrage: which involves a purchase in one market and a simultaneous sale in another; and 3) kind arbitrage: where there is "a purchase of a security which is, without restriction other than the payment of money, exchangeable or convertible within a reasonable time into a second security, together with a simultaneous off-setting sale of the second security." 208 F.2d at 603. It is to be noted that in *Morales v. Mapco, Inc.*, [1974-1975 Transfer Binder] CCH FED. SEC. L. REP. ¶ 95,094, at 97,875 (N.D. Okla. 1975), it was the exercise rather than the purchase of the warrant which occurred simultaneously with the sale of the underlying stock.

surable period of time to circumstances known in advance to the wrongdoer. But in acquiring the knowledge necessary for successful arbitrage, the insider is on the same footing with all the world, for his profit is not dependent on the policy or circumstances of the issuer, but on the coincident state of the markets. Indeed arbitrage is so clearly divorced from the abuses which § 16(b) seeks to prevent that an implied exception could be urged with some force even absent the express provisions of § 16[(e)].<sup>101</sup>

These considerations would be inapplicable to the transactions in *Mapco* where the insider consummated the sale simultaneously with the *exercise* of the warrants rather than locking itself in with a sale at the time of the *purchase* of the warrants. It remains to be seen whether the *Mapco* court's dictum regarding the simultaneity of the transactions will open up yet another Pandora's box in section 16(b) jurisprudence.

The ramifications of the new pragmatism extend far beyond the process by which the courts determine under what circumstances certain types of acquisitions and dispositions of equity securities will be subject to section 16(b). This currently emerging method of analysis has similarly been applied to the explanation of the definition of a statutory insider and to the identification of those persons and entities who are to be brought within the section's reach.

#### WHO COMES WITHIN THE SECTION'S REACH?

The preamble to section 16(b) establishes Congress's stated *ratio decidendi* for conclusively presuming that a statutory insider's profit realized from short-swing, speculative transactions should be disgorged to the corporation: "[f]or the purpose of preventing the unfair use of information . . . by such [ten percent] beneficial owner, director, or officer, *by reason of his relationship to the issuer*, any profit realized by him from any purchase *and* sale, or sale *and* purchase . . . within any period of less than six months . . ."<sup>102</sup> The framer's use of the conjunctive connection between the initial and closing transactions indicates that the short-swing prohibition was concerned with the statutory insider who had advance access to the inside information by virtue of his or her relationship to the issuer. It would follow that an initial purchase

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101. 208 F.2d at 604. *But see* Lewis v. Dekcraft Corp., [1973-1974 Transfer Binder] CCH FED. SEC. L. REP. ¶ 94,620, at 96,201-02 (S.D.N.Y. 1974) where the court refused to apply section 16(e)'s exemption to a series of purchases and sales occurring within a few days of each other since the transactions under examination had not been simultaneous and thus could not be classified as arbitrage.

102. 15 U.S.C. § 78p(b) (1970) (emphasis added).

which places the would-be defendant over the ten percent limit, consummated at a time when there had been no prior contact with the corporation, could not have been entered into on the basis of special information obtained by reason of such a relationship. However, this construction had been universally rejected by the courts prior to the emergence of the new pragmatism. Before embarking on an analysis of this problem, it is worthwhile to examine the nature of the class of persons who fall within the presumption established by the Act.

### *The Legislative Background*

On its face the section applies to officers and directors of the issuing corporation as well as to persons who are "directly or indirectly" beneficial owners of more than ten percent of a class of equity securities.<sup>103</sup> It is interesting to note the process by which Congress arrived at the arbitrary ten percent figure. The draft legislation in its early form provided that the limit be set at five percent beneficial ownership on the theory that this degree of ownership is of sufficient magnitude to "practically constitute" such proximity to corporate management so as to justify the classification of the five percent owner as an insider with access to inside information which he or she could use for his or her "own enrichment."<sup>104</sup> During the course of the senate hearings it was suggested that this provision was overbroad—a five percent owner, unlike an officer or director, does not owe any fiduciary responsibility to the remaining shareholders. In response it was pointed out that the primary factor here was not the traditional common law definition of fiduciary duties but rather access to inside or confidential information by reason of the relationship to the corporation in and of itself.<sup>105</sup>

The establishment of a fixed figure of equity ownership is thus a manifestation of the legislature's "crude rule of thumb" approach in not requiring a showing of actual control or access to information, but alternatively to create a figure at which such access could be reasonably presumed. Later on in the senate hearings it was suggested that the trigger be raised from five to twenty percent in order to avoid overreaching by the statute,<sup>106</sup> but Congress eventually arrived at a compromise

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103. See Proposed Code § 604(a) which speaks in terms of "the beneficial owner of more than ten per cent," eliminating the current "directly or indirectly" qualification. It is not clear whether this deletion was intended to eliminate many of the issues discussed herein.

104. *Hearings, supra* note 1, pt. 16, at 7741.

105. *Id.* at 7742-43.

106. *Id.* at 7743.

and increased the percentage from five to ten percent.<sup>107</sup> Notwithstanding Congressional efforts to arrive at an objective standard, albeit a crude one, in the area of defining who is subject to the Act, situations quickly arose in which courts had to look beyond the Act's language in order to determine if the alleged insider was within the purview of section 16(b). Courts have necessarily addressed themselves to the central question of the purpose of the legislation in determining the parameters of the Act's coverage.

*Who is a Beneficial Owner? And the Problem of Deputization*

The process of determining who is a ten percent beneficial owner can arise, for example, when spouses each own equity securities of the same issuer. The question then becomes whether their shares are to be aggregated rather than attributed to each separately. This problem occurs more frequently within the context of deciding whether either (or both) of the spouses is subject to section 16(a)'s reporting requirements. The SEC has defined the process of answering this type of question as the determination of whether one spouse enjoys "benefits substantially equivalent to ownership" with respect to the shares held by the other.<sup>108</sup>

The attribution of ownership between spouses, however, is not limited to establishing whether either or both is a ten percent beneficial owner. For example, an interesting twist on this aspect of the problem surfaced in *Walet v. Jefferson Lake Sulphur Co.*,<sup>109</sup> in which the defendant, a director and president of the plaintiff corporation, maintained that insofar as he and his wife were residents of Louisiana, a community property jurisdiction, one half of his short-swing profit was attributable solely to his wife's account, leaving only the other half—his half—to inure to the corporation under 16(b). The Fifth Circuit, relying heavily on the decision below, viewed the federal policy behind section 16 as supreme and refused to defer to the local law of marital

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107. In a somewhat analogous situation, Congress has recently taken the position that five percent control is sufficient to create a fiduciary responsibility on the part of the owner with respect to the Act's tender offer safeguards as established in the Williams Act. Act of Dec. 22, 1970, Pub. L. No. 91-567, §§ 1-5, 84 Stat. 1497, amending Act of July 29, 1968, Pub. L. No. 90-439, §§ 2-323, 82 Stat. 454 (codified at 15 U.S.C. §§ 78m(d)-(e), n(d)-(f) (1970)).

108. See, e.g., SEC Securities Exchange Act Release No. 34-7793 (Jan. 19, 1966), which is discussed in note 112 *infra*. See generally 2 L. Loss, *supra* note 1, at 1100-08; Feldman & Teberg, *Beneficial Ownership Under Section 16 of the Securities Exchange Act of 1934*, 17 W. RES. L. REV. 1054 (1966); Shreve, *Beneficial Ownership of Securities Held by Family Members*, 22 BUS. LAW. 431 (1967).

109. 202 F.2d 433 (5th Cir.), *cert. denied*, 346 U.S. 820 (1953).



residence on the issue of beneficial ownership. The court of appeals reasoned that to do otherwise would result in "defeat[ing] the purpose of the statute here under consideration."<sup>110</sup>

Under the more recent decisions which have considered the meaning of "beneficial" ownership, it has become evident that even if only half of the defendant's profit in *Walet* had been attributed to him, absent special facts, his wife's interest would nevertheless have been subject to the sanctions of section 16(b). This counterpart to the problem presented in *Walet* has been considered by the courts within factual settings in which the point at issue is whether the shares held by the statutory insider's spouse, and his or her trading therein, are to be considered within the proscriptions of the section. The situation has recently arisen in *Whiting v. Dow Chemical Co.*,<sup>111</sup> in which a director sought a judicial declaration that any "profit" resulting from his wife's sale of Dow Chemical's common stock within six months of a purchase by him was not subject to disgorgement under the statute.<sup>112</sup> The evidence adduced at trial led the court to conclude: "In short, the resources of both husband and wife are significantly directed toward their common prosperity, and they easily communicate concerning matters which relate to that prosperity."<sup>113</sup> The court initially distinguished

110. *Id.* at 434. See also the decision below, reported at 104 F. Supp. 20, 24-26 (E.D. La. 1952).

111. 386 F. Supp. 1130 (S.D.N.Y. 1974), *aff'd*, [1975 Transfer Binder] CCH FED. SEC. L. REP. ¶ 95,294 (2d Cir. 1975); cf. B.T. Babbitt, Inc. v. Lachner, 332 F.2d 255, 257 (2d Cir. 1964), where the parties stipulated that a sale by the wife of the director was attributable to him for 16(b) purposes.

112. Mr. Whiting had been a director since 1959 while his wife, the daughter of the company's founder, had a large interest in, though less than ten percent of, Dow Chemical's common stock. Within a three-month period Mrs. Whiting sold 29,770 shares of the common stock from which she received more than 1.6 million dollars whereas less than four months subsequent to her first sale Mr. Whiting exercised existing options for the purchase of 21,420 shares at a price of \$520,774, the payment of which had been financed through a loan from Mrs. Whiting. The company contended that Mr. Whiting was "indirectly the beneficial owner" of his wife's holdings and, hence, that he had realized a profit which must inure to the corporation under 16(b). In order to determine whether her shares were to be attributed to him, the court adopted a subjective view and found it necessary to examine their financial relationship to each other.

The SEC had previously taken the position that, at least for the purposes of section 16(a)'s reporting requirements, spouses' shares are generally attributable to each other:

Generally a person is regarded as the beneficial owner of securities held in the name of his or her spouse and their minor children. Absent special circumstances such relationship ordinarily results in such person obtaining benefits substantially equivalent to ownership, e.g., application of the income derived from such securities to maintain a common home, to meet expenses which such person otherwise would meet from other sources, or voting of such securities.

SEC Securities Exchange Act Release No. 34-7793 (Jan. 19, 1966). See generally Feldman & Teberg, *supra* note 108.

113. The testimony at trial revealed among other things that the Whitings did not mingle their assets, that the wife controlled her own investments, and that they did not

the issue before it from the question whether spouses' shares are to be aggregated for the purpose of determining whether the ten percent beneficial ownership status has been achieved: "[T]he question under § 16(b) is more narrowly whether *the insider* has 'realized profit' by 'any purchase and sale' . . . ."<sup>114</sup>

The court then drew an analogy to the "deputization" cases in which the issue is whether the insider status of a partner should be attributed to the partnership as a whole, as analyzed in the Supreme Court's decision in *Blau v. Lehman*;<sup>115</sup> in both situations the question resolves itself into what is meant by the statutory phrase "profits [*sic*] realized by him."<sup>116</sup> In order to arrive at the proper construction, the *Whiting* court took the position that each case must be examined on its facts, following the new pragmatism of *Kern County*, by characterizing the *Whitings'* transactions as "borderline." Accordingly the court viewed this as a situation that requires a substantive analysis into whether there was any potential for speculative abuse in the transactions at hand and in doing so the court placed the burden of proof of its absence upon the insider.<sup>117</sup> The *Whitings'* segregation of assets and evidence of independence of investment decisions were not deemed to be sufficient to meet that burden in the face of the evidence that they "communicated regarding financial matters deemed mutually important."<sup>118</sup> This pattern of communication was held to have created the potential for speculative

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generally discuss company affairs, all of which lead the court to conclude that Mrs. *Whiting* was not "the 'alter ego' of her insider husband." On the other hand, they were happily married, filed joint tax returns, had the same investment advisor, although they maintained distinct accounts, and one year before the transactions in question the *Whitings* did in fact discuss and revamp the general philosophy of her investments. 386 F. Supp. at 1132.

114. *Id.* at 1134 (emphasis added). In the course of its opinion the court went on to conclude that some of the readings of the 16(a) considerations may in fact be useful within the context of 16(b) and, in particular, alluded to the SEC's position on the factors to be considered by identifying "benefits substantially equivalent to those of ownership." *Id.* at 1136; see SEC Securities Exchange Act Release No. 34-7793 (Jan. 19, 1966), discussed in note 112 *supra*.

115. 368 U.S. 403 (1962). See generally, e.g., W. PAINTER, *supra* note 7, at 53-96 (1968), 15-18 (Cum. Supp. 1974). The deputization question is but another aspect of the process of determining who is subject to the Act and is discussed in the text accompanying notes 120-34 *infra*.

116. See 386 F. Supp. at 1135.

117. *Id.* at 1135-37. In so placing the burden of proof the court was adhering to the position urged by the American Law Institute. Proposed Code §§ 1413(g), (h)(2); see text accompanying notes 92-93 *supra*; cf. *Rothenberg v. Sonnabend*, [1961-1964 Transfer Binder] CCH FED. SEC. L. REP. ¶ 91,226, at 94,053 (S.D.N.Y. 1963) (whether a spouse's transactions are attributable to the insider is a question of fact).

118. 386 F. Supp. at 1137. But see *Blau v. Potter*, [1973 Transfer Binder] CCH FED. SEC. L. REP. ¶ 94,115, at 94,478 (S.D.N.Y. 1973), where the court reached the opposite result.

abuse since any inside information which was presumed accessible to the husband as a director was, under these facts, equally presumed to have been communicated to his wife. This type of reasoning may well lead to an additional expansion of the scope of section 16(b) under the guise of the new pragmatism. By extending liability to both tippers and tippees of inside information<sup>119</sup> and judicially incorporating into 16(b) a conclusive presumption that such tipping activity has taken place, at least within the confines of the insider's immediate family, it might even be viewed as a parallel to recent developments under rule 10b-5.

As was recognized by the district court, the issue in *Whiting* is similar to that involved in the "deputization" cases in which, for example, the statutory insider is also a member of a partnership which has an interest in the issuer's equity securities. Unlike the beneficial ownership problem, however, there is no comparable reporting requirement question since the Commission has long taken the position that "[i]f the partnership holds any equity security of that Company, the director should file reports in respect of the holdings of the partnership in such equity securities *to the extent of his pro-rata interest in the partnership.*"<sup>120</sup> In contrast, the outcome in the deputization situation under the remedial provisions of 16(b) is not governed by such black letter rubric.

The landmark opinion in this area is found in the Supreme Court's decision in *Blau v. Lehman*.<sup>121</sup> Joseph Thomas was a director of Tide Water Associated Oil Company as well as a partner in the brokerage firm of Lehman Brothers which had realized short-swing profits by trading for its own account in Tide Water stock within a six-month period. It was beyond question that Thomas was liable for his pro rata share of the firm's profit, and the sole issue for decision was whether the *entire* profit realized by Lehman Brothers should inure to the corporation by reason of Thomas's "relationship to the issuer." The evidence was in conflict as to whether there had been actual deputization of Thomas to act as a Tide Water director by the brokerage firm, and there was no evidence of actual abuse of inside information. Accordingly, the trial court refused to require reimbursement of the partnership's entire

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119. See, e.g., *Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 495 F.2d 228 (2d Cir. 1974); *Financial Indus. Fund, Inc. v. McDonnell Douglas Corp.*, 474 F.2d 514 (10th Cir. 1973).

120. SEC Securities Exchange Act Release No. 1965 (Dec. 21, 1938); accord, *Stirling v. Chemical Bank*, [1974-1975 Transfer Binder] CCH FED. SEC. L. REP. ¶ 94,810, at 96,701 (S.D.N.Y. 1974).

121. 368 U.S. 403 (1962); see, e.g., 5 L. Loss, *supra* note 1, at 3071-73.

profit.<sup>122</sup> The plaintiff, supported by a SEC *amicus* brief, contended that, notwithstanding the factual findings below, the Court should hold the partnership liable as a matter of law: "The argument of petitioner and the Commission seems to go as far to suggest that § 16(b)'s forfeiture of profits should be extended to include all persons realizing 'short-swing' profits who either act on the basis of 'inside' information or have the *possibility* of inside information."<sup>123</sup> The Court rejected this construction, relying in part upon an early draft of the Act which would have reached the tippees of insider tipplers;<sup>124</sup> and, over Justice Douglas's dissent, affirmed the position taken below.

It seems appropriate to question whether in the face of the new pragmatism this view of deputization will survive. More specifically, the Court's subsequent decision in the *Kern County* case accepts the speculative abuse test within the context of an unorthodox purchase and sale. Under this rationale, is it so unreasonable to go to the next step and apply the *potential* for abuse test to the deputization situation? In this regard, the district court in *Whiting*, under the teachings of *Kern County*, attributed the wife's shares to her husband despite the absence of any evidence of *actual* abuse since there was the *potential* for the communication of inside information. Certainly, the common economic interests of a husband and wife are no greater than that of a partner vis

122. *Blau v. Lehman*, 173 F. Supp. 590, 593 (S.D.N.Y. 1959), wherein the court relied on *Rattner v. Lehman*, 193 F.2d 564, 565 (2d Cir. 1952). On appeal in *Blau* the Second Circuit reaffirmed the *Rattner* holding, 286 F.2d 786, 789 (2d Cir. 1960).

123. 368 U.S. at 411 (emphasis added).

124. Thus, § 15(b) of both H.R. 7852, and S. 2693, 73d Cong., 2d Sess. provided:

"(b) *It shall be unlawful for any director, officer, or owner of securities, owning as of record and/or beneficially more than 5 per centum of any class of stock of any issuer, any security of which is registered on a national securities exchange . . . (3) To disclose, directly or indirectly, any confidential information regarding or affecting any such registered security not necessary or proper to be disclosed as part of his corporate duties. Any profit made by any person, to whom such unlawful disclosure shall have been made, in respect of any transaction or transactions in such registered security within a period not exceeding six months after such disclosure shall inure to and be recoverable by the issuer unless such person shall have had no reasonable ground to believe that the disclosure was confidential or was made not in the performance of corporate duties. . . .*" (Emphasis added).

As to the meaning ascribed to this provision, see Hearings before the Committee on Banking and Currency on S. Res. No. 84, 72d Cong., 2d Sess., and S. Res. Nos. 56 and 97, 73d Cong., 1st and 2d Sess. 6555, 6558, 6560-6561; Hearings before Committee on Interstate and Foreign Commerce on H.R. 7852 and H.R. 8720, 73d Cong., 2d Sess. 135-137. These hearings seem to indicate that the provision was omitted from the final act because of anticipated problems of administration. See also *Smolowe v. Delendo Corp.*, 136 F. 2d 231, 236; *Rattner v. Lehman*, 193 F. 2d 564.

368 U.S. at 412 n.12.

a vis his or her partnership as a whole. Furthermore, the very nature of the partnership form imposes upon the partner various fiduciary duties relating to the partnership's well-being which have no counterpart in the marriage relationship.

Some six years after the *Lehman* decision, the Second Circuit in *Feder v. Martin Marietta Corp.*<sup>125</sup> seemed to retreat from the position that the possibility of a tip of inside information is not sufficient to justify deputization. In *Martin Marietta*, defendant Martin Marietta's chief executive officer, who was also a director thereof, was a director of Sperry Rand Corporation in which the defendant held a large amount of stock. Within six months of its purchase of more than 100,000 Sperry shares, the Martin Marietta director resigned from Sperry's board and the corporate defendant sold its holdings at a profit. The Second Circuit took note of a recurring pattern based on the defendant's practice of having a representative on the board of any company in which it owned a substantial number of shares. This, when combined with the fact that its representative on Sperry's board had participated in discussions with other Martin Marietta personnel about its Sperry holdings, led the court to find the deputization doctrine applicable with respect to Martin Marietta's short-swing profit.<sup>126</sup> Although there was no evidence of the actual communication of Sperry inside information to Martin Marietta, the fact there was some communication relating to the defendant's investment position presented a sufficient possibility (or probability) of abuse.<sup>127</sup> In other words, reading *Blau v. Lehman* in light of *Martin Marietta* and the test as spelled out in *Kern County*, while the mere possibility of the communication is not sufficient, a showing of opportunity is enough, albeit short of proof of actual abuse.

More recently, the District Court for the Southern District of New York was called upon to re-evaluate the Second Circuit's position in the case of *Popkin v. Dingman*.<sup>128</sup> The individual defendants Dingman and Halliday were officers and directors of Allied Equities; in addition each

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125. 406 F.2d 260 (2d Cir. 1969).

126. *Id.* at 266. See generally, e.g., Wagner, *Deputization Under Section 16(b): The Implications of Feder v. Martin Marietta Corporation*, 78 YALE L.J. 1151 (1969).

127. In this regard the Fourth Circuit has noted: "The issue is not whether there was 'actual abuse of insider information' or 'intent to profit on the basis of such information.' These considerations are irrelevant. It is specifically whether the defendant 'had or was likely to have access to inside information . . . so as to afford it [or him] an opportunity to reap speculative, short-swing profits' from the unorthodox transaction." *Gold v. Sloan*, 486 F.2d 340, 343-44 (4th Cir. 1973), cert. denied, 419 U.S. 873 (1974), relying on *Kern County Land Co. v. Occidental Petroleum Corp.*, 411 U.S. 582, 595-96 (1973) (footnotes omitted).

128. 366 F. Supp. 534 (S.D.N.Y. 1973).

owned large blocks of Allied stock.<sup>129</sup> Allied in turn held a large block of stock in Wheelabrator-Frye, and Halliday was the chairman of its board. These factors were sufficient to establish both as statutory insiders. On March 22, 1972, Allied sold its entire interest in Wheelabrator-Frye with the codefendants abstaining in the Allied board's vote. Within the six months preceding Allied's sale, Dingman and Halliday had each purchased Wheelabrator-Frye stock at a price lower than that realized by Allied on March 22. The plaintiffs urged the court to attribute the defendants' pro rata portion of Allied's sale to them individually, hence resulting in a profit which would inure to Wheelabrator-Frye under section 16(b).

In comparison to the position taken in the *Whiting* case, the *Popkin* court quickly dismissed the contention that this was an "unorthodox" transaction, employed the objective test where the possibility of speculative abuse was not at issue, and found that there could be no liability since the individual defendants did not sell and their only benefit from Allied's sale was too indirect since Allied used the proceeds of the sale to pay off a pre-existing debt. The court noted that the interest of a shareholder in a profit by the trading corporation—*i.e.* Allied—is only derivative, as opposed the direct interest which a partner has in the profits of the partnership.<sup>130</sup>

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129. Dingman owned between 3.4 and 4.8 percent of Allied while Halliday owned between twelve and fourteen percent.

130. 366 F. Supp. at 539. The court also rejected the plaintiff's analogy to *Blau v. Mission Corp.*, 212 F.2d 77 (2d Cir.), *cert. denied*, 347 U.S. 1016 (1954); *Blau v. Lamb*, 242 F. Supp. 151 (S.D.N.Y. 1965), *modified on other grounds*, 363 F.2d 507 (2d Cir. 1966), *cert. denied*, 385 U.S. 1002 (1967) and *Marquette Cement Mfg. Co. v. Andreas*, 239 F. Supp. 962 (S.D.N.Y. 1965), where a shareholder was held liable for short-swing transactions by the corporation. In the *Mission* case the trading corporation in question was an investment company the sole purpose of which was to serve as a holding company for the defendant's investments. Similarly in *Lamb* the defendant owned the vast majority of the trading corporation's stock and executed full control over its directors. And in *Marquette Cement* the individual defendant was the sole trustee of nineteen trusts which held all of the stock in the trading corporation. Whereas in the instant case Allied was not established for the sole benefit of the defendants, nor did they exert control as they did not participate in Allied's decision to liquidate its Wheelabrator-Frye holdings. *Cf.* *Shattuck Denn Mining Corp. v. La Morte*, [1973-1974 Transfer Binder] CCH FED. SEC. L. REP. ¶ 94,429, at 95,471 (S.D.N.Y. 1974); *Landy v. United Fruit Co.*, 305 F. Supp. 254 (D.N.J. 1969). For the factors to be considered in the analogous situation of determining whether shares held in trust are to be attributed to the trustee, *see, e.g.*, *A. Hollander & Son, Inc.*, 8 S.E.C. 586 (1941); *Ohio Cas. Corp.*, [1971-1972 Transfer Binder] CCH FED. SEC. L. REP. ¶ 78,412 (SEC Div. of Corp. Fin. 1971); *A. George Bullock*, 2d, [1971-1972 Transfer Binder] CCH FED. SEC. L. REP. ¶ 78,363 (SEC Div. of Corp. Fin. 1971); Securities Exchange Act Rule 16a-8, 17 C.F.R. § 240.16a-8 (1970); SEC Securities Exchange Act Release No. 34-4720 (June 18, 1952).

Thus, in *Popkin*, as opposed to the other cases discussed above, the court looked solely at the economic benefit that the reputed insider achieved directly from the transaction; the analysis there fell short of scrutinizing the relationship of the insider to the trading entity, or would-be attributee, in search of the possibility of communication of inside information prior to the transaction(s) in question. In its attempt to resurrect predictability in the law governing recapture of short-swing profits, the American Law Institute's present version of its proposed legislation reverses its earlier silence on the issue and explicitly rejects the deputization theory as a basis for strict liability by excluding deputies from the definition of "director."<sup>131</sup>

A new wrinkle in the deputization issue arose in *Alloys Unlimited, Inc. v. Gilbert*<sup>132</sup> in connection with a pledgee's sale of the insider's stock within six months of a purchase by the insider. The defendant Gilbert, a vice president and director of Alloys Unlimited, had pledged his shares with Securities National Bank as collateral for a personal loan. After the pledge Gilbert purchased unregistered Alloys Unlimited shares. Within six months of this purchase but more than six months after the pledge, the bank, after having notified Gilbert, sold the same number of shares. The defendant argued that the proceeds from the bank's sale could not be reallocated to him for 16(b) purposes since the bank, as pledgee, had unfettered control over the collateral. The court responded by holding section 16(b) applicable because of the potential for speculative abuse by Gilbert.<sup>133</sup> Here, in contrast to its rejection of the judicially-created deputization theory, the Proposed Code would codify the *Alloys Unlimited* approach in every such case by attributing

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131. See Proposed Code § 1413, Comment 4. Compare *id.* § 226 (Tent. Draft No. 1, 1972) with *id.* § 226 (Tent. Draft No. 2, 1973). However, the drafters did not take it upon themselves to clarify the broader problem of determining what is meant by *beneficial* ownership, see *id.* § 604(a).

132. 319 F. Supp. 617 (S.D.N.Y. 1970).

133. If a sale of pledged collateral were to be excluded from the prohibition of Section 16(b), an insider, after a sharp increase in the market price of shares recently purchased by him, could, upon receiving inside information likely to depress the market price of his stock, pledge it for a loan and, when the market price declined, simply default in his obligation to put up more collateral and allow the lender to sell the collateral to satisfy the loan. The same speculative maneuver would be feasible with respect to earlier pledged stock, depending upon the nature of the inside information. We must, therefore, conclude that the bank's sale of the shares owned by defendant and held in his name constitutes a "sale" within the meaning of Section 16(b).  
*Id.* at 619; cf. *SEC v. Guild Films Co.*, 279 F.2d 485 (2d Cir.), cert. denied, 364 U.S. 819 (1960) (where the court enjoined the sale of pledged unregistered securities on the grounds that this would have been an illegal sale under sections 2(3) and 5 of the 1933 Act, now codified as amended at 15 U.S.C. §§ 77b(3), e (1970)).

the pledgee's sale or purchase to the pledgor.<sup>134</sup>

Both the case law and the Proposed Code present inconsistencies in their respective constructions of what is meant by beneficial ownership. The courts have attempted to achieve the purported statutory purpose in their application of the new pragmatism by examining each case on its own facts. The proposed legislation would at least eliminate this need for subjective analysis by adopting predictable rules which would codify the statute's scope.

### *Who is an "Officer"?*

Another area in which the courts have been called upon to examine what type of access to inside information is necessary to trigger section 16(b)'s remedial provisions is the determination whether the short-swing trader is an "officer" under the terms of the statute's definition of an *insider*.<sup>135</sup> In exercising its rulemaking power under the Exchange Act, the Commission has promulgated the following definition which appears in rule 3b-2: "The term 'officer' means a president, vice president, treasurer, secretary, comptroller, and any other person who performs for an issuer, whether incorporated or unincorporated, functions, corresponding to those performed by the foregoing officers."<sup>136</sup> With the majority of major modern corporations having extensive management structures that designate a variety of high level employees as "officers," the question becomes at what level of the managerial stratification the line is to be drawn between section 16(b) insiders and outsiders.

This was the issue before the court in *Colby v. Klune*,<sup>137</sup> in which the defendant Klune, who was the production manager for Twentieth Century Fox Film Corporation, had realized short-swing profits from his trading in Fox stock. While Klune was neither a ten percent owner nor was he officially designated an officer or director, the plaintiff

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134. A bona fide pledge or loan of a security does not involve a purchase or sale for purposes of this section, but *this section applies to a purchase by a pledgor or security lender before or within a period of less than six months after the date of a pledge or security loan (or during the life of a pledge or security loan) and a sale by the pledgee or security borrower, within a period of less than six months after the pledgor's or security lender's purchase, of a security that came from the pledgor or security lender, and any profit is attributable to the pledgor or security lender.*

Proposed Code § 1413(f)(3) (emphasis added); *see id.*, Comment 10.

135. *See, e.g.*, Comment, *Who is an "Officer" Under Section 16(b)—Who Knows?*, 12 SAN DIEGO L. REV. 378 (1975).

136. 17 C.F.R. § 240.3b-2 (1974). In contrast to having left this question open-ended, Congress included a definition of director within the statutory text, Exchange Act § 3(a)(7); 15 U.S.C. § 78c(a)(7) (1970).

137. 178 F.2d 872 (2d Cir.), *rev'g* 83 F. Supp. 159 (S.D.N.Y. 1949).



maintained that he was nevertheless subject to section 16(b) since he "performed the duties of an officer."<sup>138</sup> The trial court, on cross motions for summary judgment, found that although Klune's duties may have been comparable to the functions of officers of other corporations, this factor was not sufficient to render him a 16(b) insider since rule 3b-2's catch-all provision was held applicable solely to the functions of officers of the issuer, notwithstanding the fact that his position may have given him "special knowledge of corporate affairs."<sup>139</sup> On appeal, the Second Circuit reversed the summary judgment for the defendant. The court of appeals, assuming *arguendo* the invalidity of the Commission's definition of officer, gleaned the following guidelines for the definition of "officer" from the thrust of the statute itself:

It includes, *inter alia*, a corporate employee performing important executive duties of such character that he *would be likely*, in discharging these duties, to obtain confidential information about the company's affairs that would aid him if he engaged in personal market transactions. It is immaterial how his functions are labelled or how defined in the by-laws, or that he does or does not act under the supervision of some other corporate representative.<sup>140</sup>

On the other hand, the court reasoned that even if rule 3b-2's validity were to be upheld, the same type of factors would have to be considered since the functions of the officers specifically named in the rule "are not so well settled as to be self-evident."<sup>141</sup> Under both approaches the court was adopting a subjective method of analysis, looking beyond the face of the statute and of the rule by requiring an examination of whether the shortswing trader had sufficient access to inside information "by reason of his relationship to the issuer."<sup>142</sup>

The *Colby* test was reconsidered in two cases involving short-swing profits realized by the assistant treasurer and the assistant secretary of the Lockheed Aircraft Corporation. In both instances the defendant was held not to have been a statutory insider.<sup>143</sup> In the first decision the

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138. 83 F. Supp. at 160-61; see rule 3b-2, cited in text accompanying note 136 *supra*.

139. 83 F. Supp. at 161.

140. 178 F.2d at 873 (emphasis added).

141. *Id.* at 875.

142. Exchange Act § 16(b), 15 U.S.C. § 78p(b) (1970). See, e.g., *Lockheed Aircraft Corp. v. Campbell*, 110 F. Supp. 282, 286 (S.D. Cal. 1953).

143. *Lockheed Aircraft Corp. v. Campbell*, 110 F. Supp. 282 (S.D. Cal. 1953); *Lockheed Aircraft Corp. v. Rathman*, 106 F. Supp. 810 (S.D. Cal. 1952). The transactions in question originated from purchases arising out of an employee stock option plan under which the defendants' supervisors, namely the comptroller and secretary, were excluded for fear of the possible 16(b) ramifications from their tracking activities.

court noted that it is not sufficient that the defendant "assists" one of the enumerated officers in performing that officer's functions, but, rather, that he or she perform such functions himself or herself in order to fall within the purview of the statute.<sup>144</sup> In the second case of the assistant treasurer who had been promoted to assistant secretary, the court applied the *Colby* test, reasoning that since "[d]etermination of financial policy, either in a direct or consultive way, was outside his province," he was not an officer under rule 3b-2.<sup>145</sup> In a subsequent decision the District Court for the Southern District of New York limited the subjective approach to alleged insiders who are not among the officers expressly enumerated in the text of the Commission's definition.<sup>146</sup> This can be seen as the corollary to the rule that the subjective speculative abuse test applies to the unorthodox as opposed to the garden variety transaction. The absence of recent decisions leaves open the question of the extent to which the new pragmatism will be developed in determining the scope of section 16's definition of "officer."

*At What Point Does an "Insider" Become Subject to Section 16(b)'s Sanctions?*

By its terms section 16(b)'s coverage extends to all persons and entities who are subject to the reporting requirements of section 16(a) with the proviso that: "[t]his subsection shall not be construed to cover any transaction where such beneficial owner was not such *both at the time of* the purchase and sale, or the sale and purchase . . . ."<sup>147</sup> On various occasions the courts have been confronted with the problem of whether the initial acquisition which places the purchaser above the ten percent floor constitutes a "purchase" within the context of section 16(b) or, to put it in terms of the statutory rubric, is "at the time of" to be interpreted as meaning *simultaneously with or prior to*?<sup>148</sup> In all

144. *Lockheed Aircraft Corp. v. Rathman*, 106 F. Supp. 810 (S.D. Cal. 1952).

145. *Lockheed Aircraft Corp. v. Campbell*, 110 F. Supp. 282, 286 (S.D. Cal. 1953).

146. *Schimmel v. Goldman*, 57 F.R.D. 481, 486 (S.D.N.Y. 1973) (corporate vice president). Compare *Gold v. Scurlock*, 324 F. Supp. 1211, 1215 (E.D. Va. 1971), *cert. denied*, 419 U.S. 873 (1974), *modified on other grounds sub nom. Gold v. Sloan*, 486 F.2d 340 (4th Cir. 1973), with *Morales v. Holiday Inns*, 366 F. Supp. 760 (S.D. N.Y. 1973) (corporate vice president) and *Selas Corp. of America v. Voogd*, 365 F. Supp. 1268 (E.D. Pa. 1973) (same).

147. 15 U.S.C. § 78p(b) (1970) (emphasis added).

148. See *Provident Sec. Co. v. Foremost-McKesson, Inc.*, 506 F.2d 601, 607-14 (9th Cir. 1974), *cert. granted*, 420 U.S. 923 (1975); *Emerson Elec. Co. v. Reliance Elec. Co.*, 434 F.2d 918, 923 (8th Cir. 1970), *aff'd on other grounds*, 404 U.S. 418 (1972); *Bershad v. McDonough*, 428 F.2d 693 (7th Cir. 1970), *cert. denied*, 400 U.S. 992

instances, with the significant exception of the most recent decisions on point,<sup>149</sup> the courts have adopted the view that "at the time of" means simultaneously with, thus holding the threshold acquisition of a more than ten percent beneficial ownership to be a "purchase" for the purposes of determining whether a short-swing transaction has in fact occurred.

The treatment of this issue goes to the heart of the statute insofar as its resolution necessarily identifies the type of speculation at which the provision is aimed. The problem can be framed in terms of whether the ultimate evil is the short term nature of the transaction—*i.e.* a purchase *and* sale, or sale *and* purchase, within six months—where there is a potential for speculative abuse at *either* end, or whether to be in contravention of the Act *both* the purchase and the sale must be susceptible to the presumption of having been contemplated and consummated on the basis of advanced confidential inside information not available to the general public.

The legislative history in this area is sparse, but one can find the arguable implication that in 1934 Congress was concerned with the latter situation, in which an insider has advance knowledge and seeks to cash in on that knowledge by means of short term trading and by *speculating* in the corporation's stock without the down-trend risks which normally attach to such speculation. For example, in Thomas Corcoran's frequently cited statement highlighting the objective, or "crude rule of thumb" nature of section 16(b), he was addressing his remarks to one who is conclusively presumed to have made the statutory "purchase" (or "sale") with the intent of taking advantage of a "*sure thing*"<sup>150</sup> speculation which would result in a quick profit:

You hold the director, irrespective of any [actual] intention or expectation to sell the security within 6 months after, because it will be absolutely impossible to prove the existence of such intention

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(1971); *Stella v. Graham-Paige Motors Corp.*, 232 F.2d 299 (2d Cir. 1956), *cert. denied*, 352 U.S. 831 (1956), *modifying on other grounds*, 104 F. Supp. 957 (S.D.N.Y. 1952); *Allis-Chalmers Mfg. Co. v. Gulf & Western Indus., Inc.*, 372 F. Supp. 570 (N.D. Ill. 1974), *rev'd in part*, [1975 Transfer Binder] CCH FED. SEC. L. REP. ¶ 95,308 (7th Cir. 1975); *Arkansas Louisiana Gas Co. v. W.R. Stephens Inv. Co.*, 141 F. Supp. 841 (W.D. Ark. 1956).

149. *Allis-Chalmers Mfg. Co. v. Gulf & W. Indus.*, [1975 Transfer Binder] CCH FED. SEC. L. REP. ¶ 95,308 (7th Cir. 1975), *rev'g in part* 372 F. Supp. 570 (N.D. Ill. 1974); *Provident Sec. Co. v. Foremost-McKesson, Inc.*, 506 F.2d 601 (9th Cir. 1974), *cert. granted*, 420 U.S. 923 (1975). *See, e.g.*, Note, *Securities—Section 16(b)—Initial Purchase of Ten Percent of a Class of Equity Securities Is Not a Section 16(b) Purchase*, 43 FORDHAM L. REV. 678 (1975); Note, *Securities Regulation—Section 16(b)—Ten Percent Beneficial Ownership Must Exist Prior to Both a Purchase and Sale for Liability to Attach*, 53 TEXAS L. REV. 857 (1975).

150. 10 SEC ANN. REP. 50 (1944).

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.*<sup>151</sup>

This rationale was also considered appropriate when dealing with a ten percent shareholder who was neither an officer nor a director.<sup>152</sup> It was at least partially on the basis of the foregoing remarks that the Ninth Circuit held section 16(b) not applicable to the initial purchase of more than ten percent of the stock.<sup>153</sup> However, in what appears to be one of the anomalies of the statute, the "at the time of" proviso is limited to the ten percent owner but no such limitation is expressly placed upon the liability of an officer or director who purchases and sells within six months.

Within one year of the enactment of the section, Congress duplicated its provisions in section 17 of the 1935 Holding Company Act,<sup>154</sup> which contains two significant departures from its predecessor, the Exchange Act. In the first place, the Holding Company Act's remedial sanctions for insider short-swing profits are limited to officers and directors. Secondly, and more significantly, that section's proviso exempts transactions "where such person was not an officer or director *at the times of the purchase and sale, or the sale and purchase . . .*"<sup>155</sup> The significance of section 17(b)'s proviso can be argued on both sides. First, Congress's express inclusion of officers and directors in the 1935 Act's proviso can be viewed as evidence of intended different treatment of officers and directors, as compared with beneficial owners under the 1934 Act. On the other hand it can be argued that the text of the later provision shows that it was a legislative oversight not to have included officers and directors in the 1934 Act's proviso. While the status of an officer or director under the Exchange Act has been before the courts on various occasions, there has been no judicial attempt to draw an analogy to the Holding Company Act.

In *Adler v. Klawans*<sup>156</sup> the Second Circuit utilized the objective

151. *Hearings, supra* note 1, pt. 15, at 6557 (emphasis added).

152. *Id.*, pt. 16, at 7741-43.

153. *Provident Sec. Co. v. Foremost-McKesson, Inc.*, 506 F.2d 601, 610-13 (9th Cir. 1974), *cert. granted*, 420 U.S. 923 (1975); *accord, Allis-Chalmers Mfg. Co. v. Gulf & W. Indus.*, [1975 Transfer Binder] CCH FED. SEC. L. REP. ¶ 95,308 (7th Cir. 1975), *rev'g in part* 372 F. Supp. 570 (N.D. Ill. 1974).

154. Act of Aug. 26, 1935, ch. 687, tit. I, § 17, 49 Stat. 830 (codified at 15 U.S.C. § 79q (1970)). See notes 14-20 and accompanying text *supra*. See also Investment Company Act § 30(f), 15 U.S.C. § 80a-29(f) (1970), which also provides for short-swing sanctions without spelling out its proscriptions by specific reference to 16(b).

155. 15 U.S.C. § 79q(b) (1970) (emphasis added).

156. 267 F.2d 840 (2d Cir. 1959).

approach and approved the distinction under 16(b)'s proviso. There, the defendant had purchased a large, but less than ten percent, block of the stock of Williams-McWilliams Industries; five months later he was elected to the board of directors. Within ten days of his election, the defendant realized a short-swing profit by selling a large portion of his holdings. The court viewed the statute as extending in coverage to anyone who was "within one of the proscribed categories . . . at some time" during the six month period within which the purchase and sale occurred.<sup>157</sup> The court thus seemed to minimize prevention of insider speculation as the statute's prime purpose, stressing a broader policy of curtailing the "widespread abuse of fiduciary relationship[s]"<sup>158</sup> which today would fall more appropriately within the purview of the more expansive coverage of rule 10b-5.<sup>159</sup>

The Second Circuit's strict statutory construction in *Adler* has been followed in every instance in which the courts have been faced with an officer or director who occupied that position at some time during the six-month period within which his or her short-swing profit was realized.<sup>160</sup> In 1975, the Third Circuit adhered to the objective approach in its holding of nonliability for short-swing profits realized within two days of the retirement of the defendant officer and director.<sup>161</sup> David Hill had been an officer and director of PPG Industries from 1954 until September 28, 1971, when he resigned both positions. During his tenure Hill had amassed stock options pursuant to an incentive plan. Within two days after his retirement, Hill exercised the options and acquired 7,282 shares of PPG common and sold 6,800 shares. He duly reported these transactions to the SEC in compliance with section 16(a).<sup>162</sup> The plaintiff argued, and the court conceded, that a recently resigned officer or director "is likely to have inside information" that would give him or her "an unfair advantage over other [outside] investors." Nevertheless, the Third Circuit recognized that section 16(b) is directed at "only a very narrow but highly visible form of unfair dealing by corporate insiders" and ruled that since Hill was not an insider at the time of either the purchase or sale, the section could not be called into play.<sup>163</sup> In

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157. *Id.* at 844 (emphasis added).

158. *Id.*

159. *Cf. Gold v. Sloan*, 491 F.2d 729, 731 (4th Cir. 1974).

160. *See, e.g., Feder v. Martin Marietta Corp.*, 406 F.2d 260 (2d Cir. 1969); *Popkin v. Dingman*, 366 F. Supp. 534, 541 (S.D.N.Y. 1973); *Schur v. Salzman*, 365 F. Supp. 725 (S.D.N.Y. 1973); *cf. Blau v. Allen*, 163 F. Supp. 702 (S.D.N.Y. 1958).

161. *Lewis v. Mellon Bank*, 513 F.2d 921 (3d Cir. 1975).

162. See 17 C.F.R. § 249.104 (1974) (form 4).

163. 513 F.2d at 923-25. The court referred to the Supreme Court's statement in *Reliance Electric* that "Congress did not reach every transaction in which an investor

reaching this result, the court left the door open for the application of the subjective approach under the new pragmatism with respect to post-retirement short-swing profits where the plaintiff is able to show that the resignation had been nothing more than a "sham."<sup>164</sup> The utilization of the pragmatic approach in this type case, when on its face the section would be inapplicable, would be a significant expansion of the current trend which so far has purported to be limited solely to "borderline" transactions in which alternative constructions under the Act are possible. Such an expansion would be the final step in eliminating any measure of the objectiveness of the statute and would throw 16(b) into the same subjective mold as rule 10b-5.

The *Adler* court's objectivism was extended to a different factual context in *Perfect Photo, Inc. v. Grabb*.<sup>165</sup> In that case the securities in question had not been registered on a national exchange at the time of the insider's purchase.<sup>166</sup> The defendant's sale followed the purchase within less than six months, during which period the registration had been effected. The Court in *Grabb* relied on *Adler's* "*expressio unius est exclusio alterius*" approach to 16(b)'s proviso and concluded that since the section did not expressly provide that the securities be registered both at the time of the purchase and sale, "[i]ts silence . . . may not be converted into a command."<sup>167</sup>

In reaching its conclusion in *Adler*, the Second Circuit relied heavily on *Stella v. Graham-Paige Motors Corp.*<sup>168</sup> in which the meaning of the "at the time of" proviso was given its first judicial consideration. In *Stella*, the defendant Graham-Paige Motors Corporation purchased Kaiser-Frazer common stock, which resulted in Graham-

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actually relies on inside information." 404 U.S. at 422; *accord*, *Levy v. Seaton*, 358 F. Supp. 1 (S.D.N.Y. 1973). See also *Lewis v. Varnes*, 505 F.2d 785 (2d Cir. 1974), where a director and officer of Eli Lilly & Co. who had realized short-swing profits within six months of his retirement was held not subject to 16(b). In reaching this result the Second Circuit made specific reference to the fact that the former insider had, prior to the transactions in question, sought and received advice from Eli Lilly's general counsel upon which he relied.

164. 513 F.2d at 925 n.4.

165. 205 F. Supp. 569 (E.D. Pa. 1962).

166. *Id.* Section 16(b) by its express reference to subsection (a) is limited in scope to equity securities registered under section 12 of the Exchange Act; see 15 U.S.C. § 78l (1970).

167. 205 F. Supp. at 571-72; *cf.* *Consolidated Eng'r Corp. v. Nesbit*, 102 F. Supp. 112 (S.D. Cal. 1951). In contrast, section 16's reporting requirements are triggered by the date that one becomes a statutory insider of a registered issuer or subsequently when the section 12 registration becomes effective. 15 U.S.C. § 78p(a) (1970).

168. 104 F. Supp. 957 (S.D.N.Y. 1952), *aff'd in part and rev'd in part*, 232 F.2d 299 (2d Cir.), *cert. denied*, 352 U.S. 831 (1956).

Paige owning more than ten percent of the four and three-quarter million shares of the outstanding Kaiser-Frazer common. Within six months of this purchase, the defendant sold 155,000 shares of the Kaiser-Frazer stock at a profit of more than \$434,000. Graham-Paige defended the section 16(b) action, which had been instituted by another Kaiser-Frazer shareholder, on the grounds that the acquisition of shares could not properly be considered a purchase within the reach of the section since it had not been a ten percent owner prior to that time.

While the court seemed to be acknowledging the import of the access to the information existing prior to the section 16(b) transactions,<sup>169</sup> it went on to hold that "at the time of" was to be construed as meaning "simultaneously with". The district court reasoned that should the alternative construction be accepted, thereby requiring that the defendant have been a ten percent owner prior to the statutory purchase, the direct consequence would be the creation of a rule under which the cunning insider could freely engage in the proscribed activities while insulating itself from the sanctions of the section:

If the construction urged by defendant is placed upon the exemption provision, it would be possible for a person to purchase a large block of stock, sell it out until his ownership was reduced to less than 10%, and then repeat the process, ad infinitum. A construction such as this would provide a way for the evasion of § 16(b) by principal stockholders, and render it largely ineffective to prevent some of the financial evils which led to the passage of this legislation by Congress.<sup>170</sup>

Ironically, in its subsequent decision in *Reliance Electric*<sup>171</sup> the Supreme Court failed to show any similar concern about the opportunity for evasion in an analogous situation. The Court in that case, under the guise of the objective application of the statute, exonerated the ten percent owner which had liquidated its holdings in two transactions both of which had occurred within less than six months of the initial purchase. It was reasoned that, since at the time of the second sale the defendant was no longer a ten percent owner, the statute could not be applied by virtue of the "at the time of" proviso. The Supreme Court's *sub silentio* rejection of the district court's rationale in *Stella* appears to throw that court's holding into a questionable light today.

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169. See *id.* at 959; accord, *Falco v. Donner Foundation*, 208 F.2d 600, 604 (2d Cir. 1953), discussed in text accompanying notes 99-101 *supra*. See also *Park & Tilford, Inc. v. Schulte*, 160 F.2d 984, 987 (2d Cir.), cert. denied, 332 U.S. 761 (1947).

170. 104 F. Supp. at 959.

171. 404 U.S. 418 (1972), discussed in text accompanying notes 51-55 *supra*.

On the appeal in *Stella* the Second Circuit, over a vigorous dissent, expressed in passing its agreement with the approach taken by Judge Kaufman in the district court.<sup>172</sup> As noted above, Judge Kaufman's explanation of the intended impact of the section as having been directed towards short-swing trading based on the presumed knowledge of inside information obtained in advance of the initial transaction would seem to be inconsistent with his "simultaneously with" construction. The situation might conceivably have been different had the court been faced with a series of transactions in which the defendant already owned a substantial portion, albeit less than ten percent, of the issuer's stock prior to its purchase. Had this been the case, the contention would have been that Graham-Paige did in fact have access to inside information *prior to* that time. It can be argued that even this reasoning would result in a sharp departure from the intended "crude rule of thumb" application since such advance access would then be presumed on the basis of the defendant's holding less than the statutory ten percent ownership interest.<sup>173</sup> On the other hand, the development of the new pragmatism and application of the speculative abuse test within the context of unorthodox transactions might well appear to lend support to a different approach when the purchase in question consists of the reputed insider's initial investment, as opposed to the situation in which the purchase, combined with the defendant's pre-existing holdings, bring him above the ten percent limit set by the statute.

*Stella* presented what seems to be the easier case to deny liability—that is, where the defendant had no prior holdings. In essence, Judge Kaufman ruled it sufficient for the imposition of sanctions if only one component of the two part short-swing transaction was made with the presumed access to confidential information. That the statute requires

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172. 232 F.2d 299, 300-01 (2d Cir.), *cert. denied*, 352 U.S. 831 (1956); see 232 F.2d 299, 302-05 (Hincks, J., dissenting).

173. In his dissent on appeal Judge Hincks criticized the *Stella* majority on similar grounds:

[T]he basic rationale of the Act was such that only *completed* swing transactions gave rise to the presumption of unethical use of advance information: if one purchased stock on one day, became a director on the next, and sold some of his stock on the next, any resulting profit was not recoverable by the corporation apparently because a sale alone was thought to be insufficient basis for a drastic presumption that it had been made in violation of a fiduciary duty. In principle, the same rationale is equally applicable to beneficial owners who do not become such until a given purchase is consummated.

232 F.2d at 305 (emphasis added). Of course, this view of the liability of a director who was not such at the time of the purchase was expressly rejected three years later in *Adler v. Klawans*, 267 F.2d 840 (2d Cir. 1959), where the court pointed out that the director and the ten percent owner do not stand on the same footing under the statute's "at the time of" proviso, see text accompanying notes 156-58 *supra*.



both a purchase and a sale is beyond question, and for a court to focus on only one transaction, while conceding that the other could not have been subject to abuse, appears to be in direct contravention of this statutory focus. This seems to be another instance in which rule 10b-5 rather than section 16(b) should be called into play.<sup>174</sup>

The debatable wisdom of *Stella's* "simultaneously with" construction and its potential aberrational ramifications can be seen in comparison with other types of relationships to the issuer and their treatment under section 16(b). For example, assume that *A*, who had owned more than fifty percent of *X* Corporation's common stock for several years, liquidated his or her entire holdings at a sizeable profit and that within six months after *A's* sale, *X* Corporation released adverse earnings reports which caused its stock to plummet. As a matter of common sense, one might well draw the inference that *A* had advance warning of the stock's imminent decline. However, it is undeniable that an ensuing section 16(b) action would be dismissed since the statute on its face requires both a purchase and sale, or sale and purchase within the six-month period.

Alternatively, assume that *B*, an officer of *X* Corporation, sold a large amount of *X's* stock immediately preceding the corporation's public disclosure of its adverse earnings picture and then repurchased the same number of shares within six months, when the price had bottomed-out. As was the case with the former majority shareholder, the inference is readily drawn that *B* traded on the basis of advance knowledge of the earnings report. In contrast to *A*, however, since *B* engaged in both sales and purchases within the proscribed period, 16(b) liability would attach to the differential between the total received from his or her sales and the lower repurchase price.

In a third situation, analogous to the *Stella* setting, assume that *C*, who never had any contact with *X* Corporation or its management, undertook an initial speculative purchase of a larger than ten percent interest at the low price which prevailed after the earnings reports had been issued, and subsequently sold the *X* stock at a profit within six months. The *Stella* "simultaneously with" construction, if applied, would hold *C* strictly liable under the Act while absolving *A*. Of course, this apparent anomaly can be explained by pointing to the purpose of

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174. *But see* Bankruptcy Act § 249, 11 U.S.C. § 649 (1970), which provides sanctions for a single transaction by an inside fiduciary, and *Wolf v. Weinstein*, 372 U.S. 633 (1963). *See generally, e.g.,* Brudney, *Insider Securities Dealings During Corporate Crises*, 61 MICH. L. REV. 1 (1962).

the section since it addresses itself only to the *short-swing* speculator. However, as a matter of business reality and because of the probable breach of fiduciary duty to the other shareholders, the consequences of *A*'s acts would appear to be more severe. To phrase the problem in another way, the question becomes whether the probability of abuse of advance inside information by *C*, the initial ten percent purchaser, is more akin to the situation of *A*, the fifty percent owner, or to *B*, who comes squarely within the purview of section 16(b). If one were to rank the probable culpability of *A*, *B* and *C*, *C* would certainly come out a straggling third. Until recently, however, the courts made no such distinction between *B* and *C*.

An examination of the decisions following the ruling in *Stella v. Graham-Paige Motors* indicates that the Second Circuit's resolution of the problem put the "at the time of" issue to rest—at least within the context of the initial ten percent purchaser. In the next case in which the meaning of the proviso was at issue, an Arkansas district court summarily disposed of the question by citing *Stella*, holding that the initial purchase does come within the reach of section 16(b).<sup>175</sup> More recently, the Seventh Circuit followed this view *sub silentio* by assuming that the initial purchase is subject to the Act.<sup>176</sup>

In the Eighth Circuit's opinion in the *Reliance Electric* litigation,<sup>177</sup> the court continued this trend by applying the "simultaneously with" construction to the initial purchase because of the "impracticability" of any other approach:

Illustrative of some of the mischief that would be permitted in spite of Congress' action in enacting 16(b) if we accorded with [the defendant's] contentions is an initial purchase of as large a block of stock as 51 percent or more of a corporation's stock, followed by a sale any time within six months by the stockholder who obviously within that period could obtain much inside information and also could influence, manipulate or control corporate transactions. The deterrence of such apparent potential mischief must have been within the contemplation of Congress.<sup>178</sup>

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175. *Arkansas Louisiana Gas Co. v. W.R. Stephens Inv. Co.*, 141 F. Supp. 841 (W.D. Ark. 1956).

176. *Bershad v. McDonough*, 428 F.2d 693 (7th Cir. 1970), *cert. denied*, 400 U.S. 992 (1971), *aff'g* 300 F. Supp. 1051 (N.D. Ill. 1969); *cf.* *Newmark v. RKO General, Inc.*, 425 F.2d 348 (2d Cir.), *cert. denied*, 400 U.S. 854 (1970); *Blau v. Lamb*, 363 F.2d 507 (2d Cir. 1966), *cert. denied*, 385 U.S. 1002 (1967). *But see* *Allis-Chalmers Mfg. Co. v. Gulf & W. Indus.*, [1975 Transfer Binder] CCH FED. SEC. L. REP. ¶ 95,308 (7th Cir. 1975), *rev'g in part* 372 F. Supp. 570 (N.D. Ill. 1974), in which the Seventh Circuit expressed its agreement with the *Provident Securities* "prior to" construction.

177. *Emerson Elec. Co. v. Reliance Elec. Co.*, 434 F.2d 918 (8th Cir. 1970), *aff'd on other grounds*, 404 U.S. 418 (1972).

178. *Id.* at 924 (footnote omitted). The Supreme Court noted that the question of

The court here, rather than pointing to the desirability of precluding a pair of short-swing transactions by an insider based on special knowledge, imputed to the 1934 Congress the intent of dealing with an advance intention to *gain access*—in addition to the utilization of already existing access—to inside information within the presumption established by the section. This rationale does, of course, justify holding *C* liable in the hypothetical posited above. But why, then, would Congress have included *C* while excluding *A* from the grasp of the statute?

In *Kern County* the Supreme Court had the opportunity to resolve the issue explicitly but merely stated that "it is undisputed that Occidental became a 'beneficial' owner within the terms of § 16(b) when, pursuant to its tender offer, it 'purchased' more than 10% of the outstanding shares of Old Kern."<sup>179</sup> However, inasmuch as the Court did not confront the "at the time of" issue head-on and furthermore refrained from any analysis of *Stella* and its progeny, it is quite likely that the justices intentionally skirted the issue. The argument that the *Kern County* Court did not purport to decide the issue at hand is bolstered when it is remembered that in the tender offer situation, such as was before the Court, there is not one but rather a series of purchases flowing from each tenderor. As the Ninth Circuit reasoned in *Provident Securities*, "during a tender offer, [the *Kern County* Court] may have intended that the statutory purchases occur only after the purchaser has acquired 10 percent."<sup>180</sup> It was also pointed out that the Court in *Kern County* had elsewhere indicated that for section 16(b) to apply, any access to inside knowledge must exist in advance of the statutory purchase when it ruled that Occidental's short-swing transactions in the Old Kern and Tenneco securities were not subject to speculative abuse since "they could not have been based on inside information *obtained from substantial holdings that did not yet exist*."<sup>181</sup>

In *Provident Securities* the Ninth Circuit began its analysis by dismissing the defendant's contention that the exchange of a substantial portion of its assets for Foremost-McKesson convertible debentures (which were convertible into more than ten percent of the underlying

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whether the initial ten percent purchase comes within the purview of 16(b) was not properly before it for decision. 404 U.S. at 421.

179. *Kern County Land Co. v. Occidental Petroleum Corp.*, 411 U.S. 582, 595 (1973); accord, *Allis-Chalmers Mfg. Co. v. Gulf & Western Indus., Inc.*, 372 F. Supp. 570 (N.D. Ill. 1974), *rev'd in part*, [1975 Transfer Binder] CCH FED. SEC. L. REP. ¶ 95,308 (7th Cir. 1975).

180. 506 F.2d 601, 609 (9th Cir. 1974), *cert. granted*, 420 U.S. 923 (1975).

181. *Id.*, quoting 411 U.S. at 597 (emphasis added); see text accompanying notes 56-64 *supra*.

common stock) was not an unorthodox transaction which, under *Kern County*, would have required a successful plaintiff to show that there was in fact a potential for speculative abuse.<sup>182</sup> This shifted the issue to the question whether Provident's initial acquisition was to be construed as a statutory purchase. After reviewing *Stella* and its progeny the Ninth Circuit concluded that the Supreme Court had not definitively spoken to the issue and went on to consider the question *de novo*. In doing so the court of appeals referred to an early draft of the section:

[Section 16] was originally designed to deter insiders from purchasing stock without any intention of making a long-term investment . . . [and] was directed against an insider who has no intention of changing his investment relationship to the corporation, but rather has an "intention or expectation" to purchase and sell the stock within six months. After the pair of transactions is completed he intends to own exactly the same interest in the corporation as he owned before he began his speculative venture.<sup>183</sup>

While in its early form the proscription extended only to a speculative purchase followed within six months by a preplanned sale, in response to the suggestion of Senator Buckley the section was rewritten and put into its present form in order to include within the reach of the statute the insider who, expecting a decline in price, sells the stock with the conclusively presumed intention of repurchasing when the price has reached its low.<sup>184</sup>

The Ninth Circuit explained that "there is no indication that the amendment was designed to alter the section's goal of deterring insiders from speculating on the basis of inside information *obtained because of 'substantial stockholdings.'*"<sup>185</sup> This is another way of restating the proposition that the provision was designed to catch only those short-swung transactions that at their inception are based, or conclusively presumed to be based, upon information obtained in advance by the insider, or in the words of the preamble to section 16(b), "by reason of

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182. 506 F.2d at 605.

183. *Id.* at 609. The early draft in question would have made it unlawful for an insider

[t]o purchase any such registered security with the intention or expectation of selling the same security within six months; and any profit made by such person on any transaction in such a registered security extending over a period of less than six months shall inure to and be recoverable by the issuer, irrespective of any intention or expectation on his part in entering into such transaction of holding the security purchased for a period exceeding six months.

Hearings, *supra* note 1, pt. 15, at 6430.

184. Hearings, *supra* note 1, pt. 15, at 6557-58; see Securities Exchange Act § 16(b), 15 U.S.C. § 78p(b) (1970).

185. 506 F.2d at 610 (emphasis added).

his relationship to the issuer." Accordingly, the court asserted that since the initial purchaser can only be classified as an *outsider* prior to the transaction in question, and the clear import of the section was interpreted to apply the conclusive presumption solely to statutory insiders, the purchase in question was not subject to 16(b)'s remedial sanctions.<sup>186</sup>

This approach avoids confrontation with the possibility of abuse, recognized by the district court in *Stella*, by the insider who continually speculates in such a fashion as to never have more than the ten percent trigger prior to his or her speculative purchase.<sup>187</sup> The court in *Provident Securities* addressed itself to this issue and extended the new pragmatism by opening the door for a counterpart to the speculative abuse test in reasoning that its *prior to* construction of the "at the time of" proviso is not to be applied unless the transaction in question has been effected by an outsider who becomes an insider solely as a result of that transaction.<sup>188</sup> This qualification to the court's holding renders it unclear whether the Ninth Circuit would apply the *Stella* "simultaneously with" construction to the case in which the defendant owned a substantial block of stock *prior to* the purchase which placed it above the ten percent statutory limit.<sup>189</sup>

There is an apparent internal inconsistency that emerges from the *Provident Securities* decision. The court, in indicating that the *prior to* construction is not to be applied to the closing transaction, is imputing two different meanings to the "at the time of" proviso depending on whether it is brought to bear on a "purchase" or on a "sale." Clearly, there is no objective support for this distinction on the face of the statute. However, the Ninth Circuit viewed its resolution of the question as providing "consistency of rationales" which "is much more important than a consistency of terms."<sup>190</sup> It is one thing to take the position that the statute is limited to those with advance access to inside information and quite another to say that an insider can avoid all liability simply by selling enough stock in the closing transaction to place him or her below the ten percent limit. This dicta regarding what was intended in "the time of . . . the sale" situation is the outright rejection of the Supreme

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186. See *id.* at 613-14; accord, *Allis-Chalmers Mfg. Co. v. Gulf & W. Indus.*, [1975 Transfer Binder] CCH FED. SEC. L. REP. ¶ 95,308 (7th Cir. 1975), *rev'g in part* 372 F. Supp. 570 (N.D. Ill. 1974).

187. See text accompanying note 170 *supra*.

188. 506 F.2d at 614. "This construction, however, should not be applied to a transaction that is not an initial purchase but *in reality* is a repurchase or a closing transaction." *Id.* (emphasis added).

189. See text accompanying note 173 *supra*.

190. 506 F.2d at 614.

Court's reasoning in *Reliance Electric*, which, as noted earlier, appears to be called for in light of *Kern County*.

Notwithstanding the consistency of rationales, the resulting inconsistency of terms creates a significant problem of statutory interpretation which should not be underplayed. For instance, it can be argued that had Congress fully appreciated the purported necessity of scrutinizing the initial and closing transactions in different lights, surely the framers could have arrived at a more explicit means of expressing this dichotomy on the face of the statute. On the other hand, the *simultaneously with* construction is in conflict with the version of congressional intent adopted in *Reliance Electric* which would apply a Draconian "crude rule of thumb" to a "very narrow" situation in which an individual who trades in a security at a profit within a six-month time span can be conclusively presumed to have engaged in such activity on the basis of inside information to which he or she had access in advance of the first statutory purchase or sale. The *Provident Securities* opinion utilizes the new pragmatism to preclude such an interpretation. In any event, the Ninth Circuit's dicta has presented the Supreme Court with the opportunity to resolve the apparent conflict between its most recent section 16(b) decisions.

Within the framework of the present statute courts are thus forced to choose between two possible constructions of the "at the time of" proviso, neither of which is totally satisfactory; nevertheless, it would appear that the most recent interpretation adopted in the wake of the new pragmatism by the *Provident Securities* decision is the preferable one. Additional support for the construction adopted by the Ninth Circuit can be found in the Fourth Circuit's decision in *Gold v. Sloan*,<sup>191</sup> in which the court of appeals ruled that although three of the defendants had become statutory insiders of the postmerger surviving corporation simultaneously with the closing of the merger, there could be no short-swing liability for their subsequent sales of the surviving corporation's stock since they had no access to inside information prior to the acquisition of the stock pursuant to the merger exchange. Conversely, the fourth defendant, who was found to have had such prior access by virtue of his having acted as the negotiator for the merged corporation, was held to be subject to the provisions of section 16.

In this regard the dissenter in *Gold* pointed to an apparent weak-

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191. 486 F.2d 340 (4th Cir. 1973), *cert. denied*, 419 U.S. 873 (1974). See text accompanying notes 69-77 *supra*.

ness in the position taken by the majority since none of the information so acquired by any of the defendants could have been obtained "by reason of [their] relationship to the issuer." The dissent thus urged an approach similar to the one taken in *Stella*, i.e. that the court should have scrutinized the defendants' positions with respect to the issuer after the merger but before the sale of their stock rather than limiting the inquiry by a *prior to* construction.<sup>192</sup> The *Gold* decision, when offset by this aspect of the dissent, provides another example of the courts' emphasis on the *advance* nature of the potential for access to inside information.

Professor Loss, as the Reporter for the American Law Institute's Federal Securities Code, seriously considered but rejected the elimination of a counterpart to section 16(b),<sup>193</sup> reasoning that although the jurisprudence under rule 10b-5 may to a large extent eliminate the need for a broad strict liability provision in this area, "§ 16(b) has a symbolic significance that must be, and deserves to be, recognized."<sup>194</sup> In the first instance there is this recognition of the possible desirability of limiting the scope of section 16(b) while, in contrast, proposed section 1413 broadens, or at least refrains from narrowing, the scope of liability with respect to the types of insiders under discussion herein:

(c) [*Sometime directors or officers.*] With respect to a director or officer (or a person within section 604(c)), this section applies if the defendant has that status at the time of either the purchase or the sale or at any time between the two transactions.

(d) [*Sometime 10 percent owners.*] This section applies with respect to (1) a purchase that makes a person a more than 10 percent owner within section 604(a), and (2) a sale within less than six months after the purchase that created that status, whether or not the seller has that status at the time of the sale.<sup>195</sup>

In explicitly accepting the *Stella-Adler* approach, Professor Loss

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192. When a defendant becomes an insider of an issuer as part of an opening acquisition of such issuer's stock, such defendant may be able to use information obtained thereafter, by virtue of his insider position, in timing his closing dispositions of the stock. Such an abuse is exactly the sort of evil that § 16(b) is designed to prevent. By the terms of § 16(b), a person who purchases stock of an issuer while not a director, and who later becomes a director of the issuer and sells such stock within six months of purchase, is liable under § 16(b). The statute has been so applied. *Adler v. Klawans*, 267 F.2d 840 (2[d] Cir. 1959); *Bershad v. McDonough*, 428 F.2d 693 (7[th] Cir. 1970) (alternative holding); *Marquette Cement Manufacturing Co. v. Andreas*, 239 F. Supp. 962, 966 (S.D.N.Y. 1965); *Blau v. Allen*, 163 F. Supp. 702 (S.D.N.Y. 1958). 486 F.2d at 356 (Winter, J., concurring in part and dissenting in part).

193. See text accompanying note 9 *supra*.

194. Proposed Code § 1413, Comment 2.

195. *Id.* §§ 1413(c)-(d).

acknowledges that the "construction is questionable under the present language" but adopts this version on the basis that there "is opportunity for abuse in the event of a sale *after* insider status is achieved."<sup>196</sup> Hence, the code rejects, without explanation, limitation of the evil that warrants the extreme approach of providing for strict liability in addition to the presumption of *advance* access to inside information prior to *both* ends of the short-swing transaction. In so doing there is no explanation why the section does not equally apply to a single sale by an insider. This is one of the "rough edges" that would not be ironed out by the proposed legislation.

#### CONCLUSION—WHERE DO WE GO FROM HERE?

Over the past thirty-three years, during which courts have been called upon to apply section 16(b)'s remedial sanctions to diversified factual *milieux*, the emphasis has shifted from objectivism to pragmatism and has currently evolved into the new pragmatism. Section 16(b)'s metamorphosis evidences an increasing departure from the statute's historical "crude rule of thumb" mechanism for imposing strict liability upon corporate insiders' short-swing profits. This new thrust is most understandable when considered within the context of the environment in which it arose. The continually expanding sophistication of the marketplace forced the federal judiciary to gear the section to new situations which had not been considered by the framers in 1934 and thus did not fit into the statutory mold.

In every instance—from the early conversion cases to the most recent corporate consolidation situations—in which the courts have found it necessary to scrutinize the substance of the transaction, they have been able to support their analysis with at least an arguable interpretation of the drafters' intent although, in many instances, the contrary result might have found equal support in section 16(b)'s wording and history. In other words, what had been originally intended to provide the courts with a self-determining, mechanical formula has emerged into but an analytical starting point for judicially created doctrines of liability. At the sacrifice of predictability of result, the new pragmatism represents a continued attempt to eliminate the potential for "purposeless harshness" that in certain situations necessarily arises from the imposition of strict liability.

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196. *Id.*, Comment 6.



The loss of certainty in application has appeared in related areas under the securities laws, such as rule 10b-5 liability, and may be nothing more than the inevitable result of reliance upon "vintage" legislation. Absent repeal of the section, which would place the problem of abuse of inside information solely within the ambit of 10b-5, or, alternatively, amendatory action by Congress, all indications lead to the conclusion that the new pragmatism will flourish and expand, perhaps even to the point that section 16(b) is viewed as doing no more than creating certain presumptions which may be rebutted by either party. In fact, nine years ago, prior to the widespread proliferation of the pragmatic trend, it was suggested that 16(b) be revised in order to eliminate its objective inflexibility by redrafting the section in terms of a rebuttable presumption of abuse of inside information.<sup>197</sup> To some extent the American Law Institute would follow this view today, at least in the areas of corporate reorganizations and consolidations<sup>198</sup> and perhaps, regardless of the method of achievement, this is destined to be the wave of the future.

The Institute's refusal to support the repeal of section 16(b) is well founded given the current state of the law under 10b-5. The argument in favor of repeal is premised primarily upon 10b-5's ability to reach the problems that may arise out of insider trading. This position is meritorious to the extent that rigorous enforcement of the antifraud provisions will act as a sufficient deterrent; however, it ignores a second and equally important aspect of 16(b)—its remedial and compensatory effect. Under the current framework the fruits of insider short-swing transactions inure to the corporation on the basis of the theory that the insider has misappropriated a corporate asset.<sup>199</sup> In contrast, the Su-

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197. Munter, *supra* note 11, wherein the author also proposed that 16(b) enforcement be taken out of the private sector and vested in the SEC. *But see* Lowenfels, *supra* note 8, at 64:

Congress has many more pressing and important problems . . . . [T]he solution would seem to lie with the federal courts. The development and extension of the subjective interpretation of section 16(b), the refusal to apply this "crude rule-of-thumb" to situations which could not possibly lend themselves to the types of abuses that the statute was designed to prevent—herein lies the most practical solution to what has in reality become a statutory anachronism.

198. Proposed Code §§ 1413(g), (h)(1).

199. *Cf.* Schein v. Chasen, 478 F.2d 817 (2d Cir. 1973), *vacated on other grounds sub nom.* Lehman Bros. v. Schein, 416 U.S. 386 (1974) (profit from trading on advance knowledge of the inaccuracy of an earnings projection should inure to the corporation); Jones v. H.F. Ahmanson & Co., 1 Cal. 3d 93, 460 P.2d 464, 81 Cal. Rptr. 592 (1969) (premium received for the sale of control should be prorated among all shareholders); Diamond v. Oreamuno, 24 N.Y.2d 494, 248 N.E.2d 910, 301 N.Y.S.2d 78 (1969) (profit from trading on advance knowledge of an adverse financial forecast should inure to the corporation).

preme Court has recently limited 10b-5 actions to purchasers and sellers of the securities, thus precluding recovery by the issuing corporation in the normal 16(b) situation.<sup>200</sup> It follows that the repeal of section 16(b) would go beyond the elimination of seemingly duplicative sanctions and would recast the compensatory focus of the present law—a result which has not been called for even by the section's harshest critics.

While the new pragmatism has its drawbacks, principally the lack of certainty which has followed from its case-by-case application, it appears to be the most satisfactory solution if applied in moderation. The courts must be mindful, however, that rule 10b-5's availability not only provides an effective weapon in and of itself but also eliminates the need for the unbridled expansion of section 16(b). The increasing complexity of securities transactions may well render a simple formula impracticable. Furthermore, as the courts continue to be confronted with "hard" fact settings, they should be able to develop a consistency of rationales which will reinject some degree of predictability without creating the type of rigidity that results in unfairness and that has led the courts to depart from the "crude rule of thumb" in striving for a refined rule of reason.

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200. *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723 (1975). Interestingly, the proposed legislation is silent on the issue of standing to sue in 10b-5 situations and thus would permit the courts to reach the contrary result. See Proposed Code § 1423, Comment 5.

