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Vincent A. Collins

West Virginia University College of Law

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SECURITIES—LIABILITY FOR SHORT-SWING PROFITS UNDER SECTION 16(b)

Since 1934¹ a controversy has raged among commentators² and the judicial circuits³ over whether the initial purchase by which one becomes the owner of 10 percent of a corporation's stock triggers the six-month period during which any profits realized from a subsequent sale are subject to forfeiture. This question has finally been answered in the negative by the United States Supreme Court in *Foremost-McKesson, Inc. v. Provident Securities Co.*⁴

The issue arose in the context of a corporate liquidation effectuated by a sale of corporate assets in exchange for debentures of the purchasing corporation. Provident Securities Company was a "family" corporation, wholly owned by the descendants of its founders. In 1968, a decision was made to liquidate Provident's assets and dissolve the corporation.⁵ Provident reached an agreement with Foremost-McKesson, Inc. whereby Foremost would buy two-thirds of Provident's assets, partly for cash and partly for \$49.75 million in Foremost convertible subordinated debentures.⁶ The

¹ *Stella v. Graham-Paige Motors Corp.*, 104 F. Supp. 957 (S.D.N.Y. 1952), was the first case to consider this element of liability under section 16(b) of the Securities Exchange Act of 1934. However, Seligman, in an article published shortly after the passage of the Securities Exchange Act of 1934, initially identified this aspect of section 16(b) as a problem area. Seligman, *Problems Under the Securities Exchange Act*, 21 VA. L. REV. 1 (1934).

² See, e.g., 2 L. LOSS, *SECURITIES REGULATION* 1060 (2d ed. 1961); 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. REV. 69 (1966); Seligman, *supra* note 1. Note, *Ten Percent Stock Ownership—Prerequisite to Section 16(b) Short-Swing Liability*, 16 B.C. IND. & COM. L. REV. 838 (1975); Note, *Is The Purchase By Which One Becomes a Ten Percent Beneficial Owner a Statutory Purchase Within the Meaning of Section 16(b)?*, 7 RUTGERS CAMDEN L.J. 104 (1975); Comment, *Short-Swing Profits and the Ten Percent Rule*, 9 STAN. L. REV. 582 (1957).

³ The courts of appeals which have dealt with this issue are those of the Second, Seventh, Eighth and Ninth Circuits. See *Allis Chalmers Mfg. Co. v. Gulf W. Indus., Inc.*, 527 F.2d 335 (7th Cir. 1975), *cert. denied*, 96 S. Ct. 1142 (1976); *Provident Sec. Co. v. Foremost-McKesson, Inc.*, 506 F.2d 601 (9th Cir. 1974); *Emerson Elec. Co. v. Reliance Elec. Co.*, 434 F.2d 918 (8th Cir. 1970); *Newmark v. RKO General, Inc.*, 425 F.2d 348 (2d Cir. 1970); *Stella v. Graham-Paige Motors Corp.*, 232 F.2d 299 (2d Cir. 1956).

⁴ 96 S. Ct. 508, 512 (1976).

⁵ *Id.*

⁶ *Id.*

agreement further provided that Foremost would register \$25 million of these debentures under the Securities Act of 1933⁷ and would participate in an underwriting agreement by which the debentures would be sold by Provident to the underwriters and through them to the public.⁸ The sale to Provident was made, and since the debentures were immediately convertible into more than 10 percent of Foremost's outstanding common stock,⁹ Provident became a 10 percent beneficial owner of a class of equity securities within the meaning of section 16(a) of the Securities Exchange Act of 1934.¹⁰ One week later, pursuant to the agreement, Provident sold debentures in the principal amount of \$25 million to the underwriters, receiving cash in the amount of \$25,366,666.66.¹¹ Having acquired and disposed of these securities within six months, Provident became concerned that it might be liable to Foremost for the profits realized on the sale of the debentures.¹² Provident therefore brought an action seeking a declaration of nonliability under section 16(b) of the Act while Foremost counterclaimed for a declaration of liability and recovery of the profit of \$366,666.66.¹³ The District Court found in favor of Provident, but on grounds other than the initial purchase question.¹⁴ The Court of Appeals for the Ninth Circuit affirmed,¹⁵ basing its conclusion on the fact that Provident was not a 10 percent owner prior to its purchase of the debentures. The Court found that by virtue of the exemptive proviso which specifies that section 16(b) shall not be construed to cover any transaction where the beneficial owner was not such "both at the time of the purchase and sale," Provident was not a statutory insider and thus not liable to Foremost for its profit upon the sale of the securities within six months.¹⁶ The United States

⁷ 15 U.S.C. § 77e-g (1970).

⁸ 96 S. Ct. at 512.

⁹ *Id.*

¹⁰ 15 U.S.C. § 78p(a) (1970). The owner of debentures convertible into more than 10 percent of an equity security is deemed a beneficial owner within the meaning of the Act. *Id.* § 78c(a)(10), (11). Rule 16a-2(b), 17 C.F.R. § 240.16a-2(b) (1975). See note 23 *infra*.

¹¹ *Provident Sec. Co. v. Foremost-McKesson, Inc.*, 331 F. Supp. 787, 790 (N.D. Cal. 1971).

¹² 96 S. Ct. at 513.

¹³ *Id.*

¹⁴ 331 F. Supp. 787 (N.D. Cal. 1971).

¹⁵ *Provident Sec. Co. v. Foremost-McKesson, Inc.*, 506 F.2d 601 (9th Cir. 1974).

¹⁶ *Id.* at 614.

Supreme Court, in a decision heavily dependent upon legislative history, unanimously affirmed the holding of the Ninth Circuit.

Section 16(b) of the Securities Exchange Act of 1934¹⁷ was enacted to deter corporate insiders from engaging in short-swing speculative trading in the securities of their own corporations.¹⁸ Its purpose was to engender investor confidence in a free and open securities market and to discourage what was believed to be a widespread abuse of the fiduciary relationship of corporate insiders.¹⁹ In order to effectively combat these abuses, section 16(b) was designed to remove any possibility of profit from short-swing insider transactions occurring within a six-month period.²⁰ Thus, section 16(b) provides for a recovery by or on behalf of the issuing

¹⁷ 15 U.S.C. § 78p(b) (1970). This section provides:

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.

¹⁸ 2 L. LOSS, *SECURITIES REGULATION* 1041 (2d ed. 1961).

¹⁹ *Adler v. Klawans*, 267 F.2d 840, 844 (2d Cir. 1959). The investigation which preceded the adoption of the Act uncovered numerous instances in which corporate insiders with access to advance information regarding changes in corporate financial policy, such as an increase or passing of dividends, were able to reap large profits at the expense of the stockholders with whom they dealt. In fact, profits from "sure thing" speculation were generally accepted by the financial community as one of the usual emoluments of office. See Cook & Feldman, *Insider Trading Under the Securities Exchange Act*, 66 HARV. L. REV. 385, 386 (1953).

²⁰ *Id.* at 407.

corporation of any "profit realized"²¹ by any corporate "insider"²² on a purchase and sale, or sale and purchase, of the issuer's equity stock²³ where both the opening and closing transactions occur within six months of each other. Insiders are deemed liable under the Act simply upon the showing of a purchase and sale within the six-month period. Section 16(b) imposes a conclusive presumption that an insider, under these circumstances, had access to inside information. Therefore, proof of lack of intent to speculate or lack

²¹ The test which the courts have unanimously chosen to apply for computation of "profit realized" is the "lowest price in—highest price out" method, first enunciated in *Smolowe v. Delendo Corp.*, 136 F.2d 231 (2d Cir.), cert. denied, 320 U.S. 751 (1943). Under this rule the profits are calculated as follows:

Listed in one column are all the purchases made during the period for which recovery of profits is sought. In another column is listed all of the sales during that period. Then the shares purchased at the lowest price are matched against an equal number of the shares sold at the highest price within six months of such purchase, and the profit computed. After that the next lowest price is matched against the next highest price and that profit is computed. Then, the same process is repeated until all the shares in the purchase column which may be matched against shares sold for higher prices in the sales column have been matched off. The gross recovery is the sum of profits thus determined.

Rubin and Feldman, *Statutory Inhibitions Upon Unfair Use of Corporate Information by Insiders*, 95 U. PA. L. REV. 468, 482-83 (1947). Under this test, an insider who has engaged in multiple transactions within a six month period could be liable for "profits" under section 16(b) even though he has sustained a net loss in his speculative transactions. For example, assume that an insider has made the following transactions within a six month period:

<u>TRANSACTION</u>	<u>NUMBER OF SHARES</u>	<u>PRICE</u>
Purchase	100	\$70
Sale	100	\$60
Purchase	100	\$50
Sale	100	\$40

The insider in this example has sustained a net loss of \$2,000, but by matching the shares purchased at the lowest price (\$50) with an equal number of shares sold at the highest price (\$60) he becomes liable for \$1,000 "profit" under section 16(b).

²² For purposes of section 16(b), "insider" means directors, officers and beneficial owners of more than 10 percent of any class of equity security. See 15 U.S.C. § 78p(a) (1970).

²³ The type of security covered by the Act is "any equity security (other than an exempted security) which is registered" pursuant to § 12 of the Act, 15 U.S.C. § 78(1). The term "equity security" has been broadly construed to include stock, warrants and convertible securities. See note 10 *supra*.

of inside information are unavailing as a defense.²⁴ However, the statute does make a distinction between individuals who are deemed insiders because of their status as officers or directors, and those who are deemed insiders because they are 10 percent beneficial owners. This distinction is created by an exemptive proviso in section 16(b) which states 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, of the security involved²⁵

Therefore, the beneficial owner must be such at "both ends" of the transaction, whereas there is no similar requirement for officers and directors. In other words, if a director or officer were such either at the time of the purchase or sale, then liability attaches under section 16(b),²⁶ but if a 10 percent owner is not such "both at the time of the purchase and sale," then liability does not attach under 16(b).²⁷ Although the phrase "at the time of" seems unambiguous and easily comprehensible, the proper interpretation has proved troublesome.

²⁴ *Smolowe v. Delendo Corp.*, 136 F.2d 231, 235 (2d Cir.) *cert. denied*, 320 U.S. 751 (1943). That strict liability was contemplated under the Act is made apparent by the remarks of Representative Thomas Corcoran, chief spokesman for the draftsmen of the Act, in Hearings Before the Committee on Banking and Currency on S. 84, 72d Cong., 2d Sess., and S. 56 and S. 97, 73d Cong., 1st and 2d Sess. 6557 (1934):

You hold the director, irrespective of any intention or expectation to sell the security within six months after, because it will be absolutely impossible to prove the existence of such intention or expectation, and you have to have this crude rule of thumb, because you cannot undertake the burden of having to prove that the director intended, at the time he bought, to get out on a short swing.

136 F.2d at 235-36.

²⁵ 15 U.S.C. § 78p(b) (1970) (emphasis added). See note 17 *supra*.

²⁶ Since there is no similar exemptive proviso applicable to officers and directors, the principle of *expressio unius est exclusio alterius* should compel the conclusion that one need only be an officer or director at *either* the time of purchase or the time of sale. See *Gold v. Sloan*, 486 F.2d 340, (4th Cir. 1973), *cert. denied*, 419 U.S. 873 (1974) (an individual who acquired stock, was simultaneously made a director, and sold his stock within six months was liable for the profits); *Feder v. Martin Marietta Corp.*, 406 F.2d 260 (2d Cir. 1969), *cert. denied*, 396 U.S. 1036 (1970) (where an individual resigns his directorship after the purchase but prior to the sale, he is a statutory insider); *Blau v. Allen*, 163 F. Supp. 702 (S.D.N.Y. 1958) (where an individual becomes a director after the purchase but prior to the sale, he also is a statutory insider).

²⁷ 15 U.S.C. § 78p(b) (1970).

From the language of the statute it is clear that one who purchases additional stock while contemporaneously owning more than 10 percent, and who sells the stock so purchased, is liable to the issuer for any profits obtained. This individual would be a 10 percent owner prior to the purchase, during the period between the purchase and the sale, and after the sale. The more difficult situation occurs when an individual owning less than 10 percent purchases an amount sufficient to carry him over the 10 percent threshold, and then sells all or a portion of his holdings within six months. Was he a 10 percent owner "at the time of the purchase?" The answer to this question depends upon whether "at the time of the purchase" means "prior to the purchase" or "immediately following the purchase."²⁸

This exact issue was first raised and exhaustively discussed in *Stella v. Graham-Paige Motors Corp.*²⁹ That case involved a purchase which brought the owner of 6¼ percent of the issuer's stock to the status of beneficial owner of 21 percent of the shares. The purchaser argued that the phrase "at the time of" should be construed to mean "prior to" the purchase and sale, and that since it owned less than 10 percent prior to the purchase, the transaction which brought it over the 10 percent line did not make it a statutory insider for section 16(b) purposes.³⁰ The court rejected this argument, stating that since the purpose of the statute was "to protect the outside stockholders against at least short-wing speculation by insiders with advance information," the statute should be interpreted broadly.³¹ Judge Kaufman, while agreeing that there was ambiguity in the exemption proviso, stated that the four crucial words "at the time of" must be construed to mean "simultaneously with" rather than "prior to" the purchase and sale.³²

Judge Kaufman believed that only this construction would be consistent with the declared purpose of the statute to prevent the

²⁸ The Court of Appeals for the Ninth Circuit employed the term "simultaneously with the purchase." This construction is equivalent to the Supreme Court language of "immediately following the purchase." For purposes of conceptual simplification the former construction will be used throughout this comment.

²⁹ 104 F. Supp. 957 (S.D.N.Y. 1952). The question was initially raised on a motion for summary judgment. The decision was reaffirmed after a trial on the merits in the same court. 132 F. Supp. 100 (S.D.N.Y. 1955), *aff'd in part, remanded in part on other grounds*, 232 F.2d 299 (2d Cir.), *cert. denied*, 352 U.S. 831 (1956).

³⁰ 104 F. Supp. at 959.

³¹ *Id.*, citing *Shaw v. Dreyfus*, 172 F.2d 140, 142 (2d Cir. 1949).

³² *Id.* at 960.

unfair use of inside information by officers, directors or owners of more than 10 percent of the equity stock.³³ The court reasoned that if the "prior to" construction were adopted, a loophole would result whereby it would be possible for a person to purchase a large block of stock on his initial purchase, sell it out until his ownership was reduced to less than 10 percent, and then repeat the process, *ad infinitum*.³⁴ The individual would not incur any liability under section 16(b). This would be an unavoidable result of the adoption of the "prior to" construction, since this shareholder would never own more than 10 percent "prior to" any purchase, yet could have nearly constant access to inside information. Judge Kaufman believed that the exemptive proviso was intended only to apply to the situation where a 10 percent owner attempted to reduce his holdings in stages.³⁵ Thus, where a 10 percent owner first reduced his holdings to just below 10 percent, and then sold the remainder of his shares in a subsequent transaction, he would be liable only for profits obtained from the first sale, since he was not a 10 percent owner at the time of the second sale.³⁶ The court of appeals affirmed these portions by Judge Kaufman's decision, agreeing that the potential loophole noted by the court would provide a mechanism by which principal stockholders could evade section 16(b) liability on short-swing transactions, thus rendering the statute largely ineffective to remedy the perceived evil.³⁷ However, Judge

³³ 15 U.S.C. § 78p(b) (1970).

³⁴ 104 F. Supp. at 959.

³⁵ *Id.* at 960.

³⁶ See *Emerson Elec. Co. v. Reliance Elec. Co.*, 434 F.2d 918 (8th Cir. 1970), *aff'd on other grounds*, 404 U.S. 418 (1972).

³⁷ *Stella v. Graham-Paige Motors Corp.*, 232 F.2d 299 (2d Cir. 1956). The commentators have generally approved of Judge Kaufman's position in *Stella*. Professor Loss has stated that "it is difficult to quarrel with the court's preference for the construction which would serve to effectuate the legislative purpose. . . ." 2 L. Loss, *Securities Regulation* 1060 (2d ed. 1961). Likewise, Messrs. Cook and Feldman (then SEC Chairman and Special Counsel, respectively), in a leading article written just after the *Stella* decision, approved Judge Kaufman's construction of the phrase "at the time of," citing with approval Judge Kaufman's statement that:

[t]o construe it to exempt a transaction unless ten percent were held both before and after would destroy the effectiveness of the section, since a person could with impunity "purchase a large block of stock, sell it out until his ownership was reduced to less than ten percent, and then repeat the process, *ad infinitum*," even though he was an insider, with access to inside information, throughout the period from the purchase to the final sale.

Hincks, in a strong dissent, asserted that there was no real ambiguity in the exemptive proviso, and that it clearly meant to exempt stockholders who did not own more than 10 percent "prior to" the initial purchase.³⁸ Judge Hincks argued that *this* was the only possible construction consonant with the purposes of the Act since the basic rationale of the Act was such that only completed swing transactions gave rise to the presumption that the insider had access to inside information.³⁹ In other words, *both* the purchase and the sale must have been made by a person with access to inside information. Since the defendant in *Stella* was not a statutory insider at the time it decided to make the initial purchase, one could not presume that the decision to effect the whole transaction, that is, the purchase and the sale, could have been made on the basis of inside information.⁴⁰

Both of these arguments are persuasive; there are two reasonable interpretations of the words "at the time of" as used in this proviso. Presuming that the statute is susceptible to differing interpretations, the task then becomes one of discerning the true legislative intent and applying that interpretation which best effectuates the legislative purpose. If section 16(b) was intended to reach all possible situations in which an insider could use his position to reap profits from short-swing speculative transactions, then Judge Kaufman's "simultaneously with" construction would be applicable. But if Judge Hincks is correct in asserting that the scope of section 16(b) is narrow, and that it is only meant to apply to the situation where an individual makes his decision to engage

Cook & Feldman, *Insider Trading under the Securities Exchange Act*, 66 HARV. L. REV. 612, 631-32 (1953), quoting *Stella v. Graham-Paige Motors Corp.*, 104 F. Supp. at 959. The SEC took a similar position, filing an amicus brief in the District Court advocating the "simultaneously with" construction and concluding "that the Congress intended to include such purchases [i.e., those by which one becomes a 10 percent shareholder] within the scope of the Act." Brief for SEC as Amicus Curiae, p. 5, *Stella v. Graham-Paige Motors Corp.*, 104 F. Supp. 957 (S.D.N.Y. 1952). Finally, the American Law Institute in its proposed Federal Securities Code would adopt the "simultaneously with" construction favored by Judge Kaufman in the *Stella* decision by imposing civil liability with respect to "a purchase that makes a person a more than 10 percent owner . . . and 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." ALI Fed. Sec. Code pt. XIV, § 1413(d) (Tent. Draft No. 2, 1973) (emphasis added).

³⁸ 232 F.2d 299, 303-4 (Hincks, J., dissenting).

³⁹ *Id.* at 305.

⁴⁰ *Id.*

in both a purchase and a sale on the basis of inside information, then a construction exempting a purchaser who could not be presumed to have made his initial purchase decision on the basis of inside information is the more correct one.

Judge Kaufman's "simultaneously with" construction has been adopted by a majority of courts which have faced the question. In *Newmark v. RKO General, Inc.*,⁴¹ the court cited an additional justification for retention of the "simultaneously with" construction. The court reasoned that while the presumption that a 10 percent owner has access to inside information "would not justify the conclusion that one who purchases a quantity of shares which makes him a ten percent beneficial owner has done so on the basis of inside information, the presumed access to such information resulting from this purchase provides him with an opportunity not available to the investing public, to sell his shares at the moment most advantageous to him."⁴² The *Stella* interpretation has also been explicitly adopted by the Eighth Circuit in *Emerson Electric Co. v. Reliance Electric Co.*,⁴³ in which the court held that this construction was consistent with Congress' purpose in enacting the statute, thus overruling *sub silentio* the only court (prior to the *Provident* court) to reach a contrary conclusion.⁴⁴ When *Reliance Electric* finally reached the United States Supreme Court, the initial purchase question was no longer relevant to the disposition of the case. However, the Court did appear to exhibit some hostility toward the broad construction implicit in the *Stella* approach by its adoption of a non-expansive, subjective construction of section 16(b), holding that the purchaser was not liable for profits derived from the second sale in a two-stage divestment, since it had sold down to 9.96 percent on the first sale.⁴⁵

⁴¹ 425 F.2d 348 (2d Cir.), *cert. denied*, 400 U.S. 854 (1970).

⁴² *Id.* at 356 (emphasis added).

The *Stella* interpretation was reaffirmed in the most recent Second Circuit decision of *Perine v. William Norton & Co. Inc.*, 509 F.2d 114 (2d Cir. 1974). *But see* *Allis Chalmers Mfg. Co. v. Gulf & W. Indus., Inc.*, 527 F.2d 335 (7th Cir. 1975), *cert. denied*, 96 S. Ct. 1142 (1976) in which the Seventh Circuit has aligned itself with the *Provident* decision of the Ninth Circuit.

⁴³ 434 F.2d 918 (8th Cir. 1970), *aff'd on other grounds*, 404 U.S. 418 (1972).

⁴⁴ *Arkansas Louisiana Gas Co. v. W. R. Stevens Inv. Co.*, 141 F. Supp. 841 (W.D. Ark. 1956). The court merely adopted Judge Hincks' dissenting opinion without analysis.

⁴⁵ *Reliance Elec. Co. v. Emerson Elec. Co.*, 404 U.S. 418, 422 (1972).

In *Kern County Land Co. v. Occidental Petroleum Corp.*,⁴⁶ the Court's preference for a subjective application of section 16(b) became clear. The majority held that the key element in defining the terms "purchase" and "sale" was whether there was any possibility of speculative abuse.⁴⁷ While the Supreme Court did not have occasion to overrule the *Stella* decision until *Provident*, the clear implication from *Reliance Electric* and *Kern County* was that the Court would not favor imposition of the harsh results which strict application of the "simultaneously with" construction could bring.

Despite some movement away from the "objective" approach of the *Stella* rationale, the courts and a majority of commentators⁴⁸ have, in the past, favored the "simultaneously with" construction when applied to the initial transaction which made a person a 10 percent owner. When *Provident* broke step with this line of cases, the district court did not directly address the question of whether a purchase creating 10 percent ownership would always be a section 16(b) transaction or, alternatively, would never be a section 16(b) transaction. The court simply adopted the *Kern County* subjective approach of applying the statute only to those situations subject to speculative manipulation.⁴⁹ The court found that this transaction did not lend itself to the type of speculative abuse which section 16(b) was designed to prevent.⁵⁰ However, the court of appeals rejected the district court's conclusion that there was not a potential for speculative abuse in this transaction.⁵¹ Admitting that *Provident* had access to inside information from the time of the purchase until the time of the sale to the underwriters, the court grounded its decision primarily upon a finding that the legislative history surrounding the enactment of section 16(b) would not support an interpretation which imposed liability on a person

⁴⁶ 411 U.S. 582 (1973).

⁴⁷ *Id.* at 594. The Court expressed the fear that if a subjective approach were not adopted, broad definitions of "purchase" and "sale" may "at least arguably, reach many transactions not ordinarily deemed a sale or purchase."

⁴⁸ For commentators who have disagreed with the *Stella* approach see Painter, *Federal Regulation of Insider Trading* (1968); Munter, note 2 *supra*; Cole, *Insiders' Liabilities under the Securities Exchange Act of 1934*, 12 SW. L.J. 147 (1958); Note, *Short-Swing Profits and the Ten Percent Rule*, 9 STAN. L. REV. 582 (1957); Comment, *Insider Liability for Short-Swing Profits: The Substance and Function of the Pragmatic Approach*, 72 MICH. L. REV. 592 (1974).

⁴⁹ 331 F. Supp. at 792.

⁵⁰ *Id.*

⁵¹ 506 F.2d at 605.

who was not a 10 percent owner prior to the initial purchase.⁵² The court then dealt with the *Stella* argument that adoption of the “prior to” construction would necessarily preclude liability in the case of a repurchase of a large block of shares subsequent to a sell-down to below 10 percent. The court rather inelegantly closed this loophole by simply limiting the “prior to” construction to the initial purchase transaction. The court acknowledged that this construction mandates that the phrase “at the time of” would mean “prior to” in the case of an opening transaction and “simultaneously with” in the case of a closing transaction, but concluded that this “inconsistency” is not inconsistent with the rationale of the section.⁵³

When *Provident* reached the Supreme Court, the analysis of the court of appeals was enthusiastically embraced.⁵⁴ The Court affirmed the Ninth Circuit’s adoption of the “prior to” construction with respect to a purchase-sale sequence but refused to express an opinion on the lower court’s application of a “simultaneously with” construction in a sale-repurchase situation.⁵⁵ In its opinion, the Court paid particular attention to the legislative history surrounding the enactment of section 16(b). While admitting

⁵² Since a person who decides to purchase enough stock to increase his holdings to 10 percent of a corporation’s outstanding shares is an outsider at the time he makes his investment decision, he does not fall within the class of persons to which the conclusive presumption [i.e., the presumption that he had access to inside information] was intended to apply. He may have made that decision on the basis of inside information, but such inside information could not have been acquired, in the language of the statute, “by reason of his relationship to the issuer,” or in the language of the Supreme Court, [in *Kern County*] “from substantial stockholdings that did not yet exist.”

Id. at 614.

⁵³ *Id.* The court attempted to justify this interpretation by citing dictum from *Reliance Electric* to the effect that:

Where alternative construction of the terms of § 16(b) are possible, those terms are to be given the construction that best serves the congressional purpose of curbing short-swing speculation by corporate insiders. 404 U.S. at 424.

The logic of this argument is difficult to grasp. Certainly this dictum does not support a conclusion that a phrase may have two entirely different meanings when applied to different words of a single sentence.

⁵⁴ 96 S. Ct. 508 (1976). Justice Powell delivered the unanimous opinion of the Court. Justice Stevens did not take part in the decision.

⁵⁵ *Id.* at 515 n.15. See *Allis Chalmers Mfg. Co. v. Gulf & W. Indus., Inc.*, 527 F.2d 335 (7th Cir. 1975), *cert. denied*, 96 S. Ct. 1142 (1976).

that there was no definite expression of congressional intent with regard to this question, the Court went on to examine the original version of what was eventually to become section 16(b). The Court found that the wording of an early draft of section 16(b) would have applied liability only where a 10 percent owner had that status before a purchase-sale was initiated, thus mandating a finding of nonliability on the part of a defendant in Provident's position.⁵⁶ However, the version that was eventually enacted did not contain the requirement that a beneficial owner must "own as of record" the threshold amount, but it did add the troublesome exemptive proviso.⁵⁷ The Court then reasoned that since the legislative history afforded no explanation of the reason for the elimination of the prior ownership requirement in the bill as enacted, it could not be presumed that Congress really meant to eliminate this requirement.⁵⁸ It is at best questionable whether the elimina-

⁵⁶ *Id.* at 517. The original draft of what was to become section 16(b) was S. 2693, 73d Cong., 2d Sess. (1934). This original draft would have extended liability to 5 percent beneficial owners, but the threshold amount was subsequently increased to 10 percent. *Hearings on S. Res. 56 and S. Res. 97 Before the Senate Comm. on Banking & Currency*, 73d Cong., 1st Sess., pt. 15, at 7741 (1934). The draft clearly would not have imposed liability on a purchaser who did not own the threshold amount prior to the purchase-sale sequence by providing in section 15(b) that

[i]t 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—

(1) To 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.

96 S. Ct. at 516-17 (emphasis added).

⁵⁷ *Id.* at 517.

⁵⁸ *Id.* at 518. The court of appeals also implied that the eliminated language should be read into the bill as enacted on the ground that if Congress had really meant to change the meaning of the draft they would have discussed the change.

The Supreme Court embraced the conclusion of the Ninth Circuit that, on the basis of hearings held in connection with S. 2693, section 16(b) was originally designed to deter insiders from purchasing stock without any intention of making a long-term investment, but only with the intention of profiting from upward fluctuations in the market price that were predictable on the basis of inside information. The section was directed against an insider who has no intention of changing his investment rela-

tion of important language from a legislative draft, without comment, supports the conclusion that it was meant to be incorporated into the final bill. But the Court went further, concluding that even in the absence of clear expressions of legislative intent it would be inappropriate to impose liability upon Provident on the basis of such unclear language, and that if Congress wished to impose such liability it should "do so expressly or by unmistakable inference."⁵⁹ The Court acknowledged that under this holding, one who purchases a more than 10 percent interest may *sell* on the basis of information obtained by virtue of his newly acquired holdings, without incurring liability under section 16(b).⁶⁰ But the Court felt that other provisions of the securities laws such as section 10(b)⁶¹ and rule 10b-5⁶² provided adequate recourse to an investor who could show harm from the actual misuse of inside information.⁶³

Finally, the Court dismissed the argument that adoption of

tionship 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 interests in the corporation as he owned before he began his speculative venture.

506 F.2d at 609.

⁵⁹ *Id.* at 520.

⁶⁰ *Id.* at 520-21. See text accompanying note 42 *supra*.

⁶¹ 15 U.S.C. § 78j(b), which provides in pertinent part:

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

⁶² 17 C.F.R. § 240.10b-5 (1975) which provides:

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,

(a) To employ any device, scheme, or artifice to defraud,

(b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

⁶³ 96 S. Ct. at 521.

the "prior to" construction rendered sections 16(d) and 16(e)⁶⁴ of the Securities Exchange Act, as well as rule 16b-2,⁶⁵ superfluous. It was properly held that these provisions would still be necessary to protect underwriters and dealers already qualifying as ten percent owners when they purchased.⁶⁶

The *Provident* case presents a close question, but in many ways the decision is an unfortunate one. It is probably true that the drafters of section 16(b) were primarily concerned with stopping double-transaction abuse, but this fact does not inevitably lead to the conclusion that they meant to ignore the problem of single-transaction insider speculation. Under this holding, one may initially purchase up to 100 percent of a corporation's stock and sell the same within six months on the basis of inside information without incurring any liability under section 16(b).

The *Provident* decision ignores the fact that a person who acquires a large block of stock in a single transaction normally *does* have access to inside information before he makes the purchase. Since he would necessarily deal in negotiations leading up to the purchase with either the issuer or an insider holding a large interest, he would be in a position to bargain for disclosures not available to the public.⁶⁷ Thus, prior to its purchase of the debentures, *Provident* could have acquired inside information by reason of its relationship to the issuer. The fact that section 10(b) and rule 10b-5 may provide an alternative remedy in cases such as this is an illusory comfort. Rule 10b-5 requires proof of actual misuse of inside information as well as injury to the plaintiff,⁶⁸ whereas section 16(b) is self-operative, requiring only a showing of a purchase and sale within six months by an insider. The mere possibility of abuse of inside information will not sustain a rule 10b-5 action since insider status does not create a presumption of access to information as it does under section 16(b). It is clear that a plaintiff's burden would be much greater in trying to recover short-swing profits under rule 10b-5 than under section 10(b). Indeed, the burden of proving intent or actual use of inside information would be

⁶⁴ 15 U.S.C. §§ 78(d), (e) (1970).

⁶⁵ 17 C.F.R. § 240.16b-2 (1975).

⁶⁶ 96 S. Ct. at 523.

⁶⁷ Brief for the SEC as Amicus Curiae at 5-6, *Stella v. Graham-Paige Motors Corp.*, 104 F. Supp. 957 (S.D.N.Y. 1952).

⁶⁸ See *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 848 (2d Cir. 1968), cert. denied *sub nom.* *Coates v. SEC*, 394 U.S. 976 (1969).

virtually insurmountable by most plaintiffs under these circumstances.⁶⁹

In *Reliance Electric*, the Supreme Court acknowledged that “the legislative history affords no explanation of the purpose of the proviso.”⁷⁰ However, with that same legislative history before them, the Court has now chosen to seize upon a fragment of that history—one of several early drafts of section 16(b) which never became law—and from this fragment adopt a construction of section 16(b) which flatly contradicts the *express* purpose of the statute which is to prevent “the unfair use of information which may have been obtained by such beneficial owner.”⁷¹

The fact that Congress has taken no action to reverse the *Stella* construction of section 16(b) during the 20 year period since that decision, strongly militates against a conclusion that this long-standing construction was contrary to congressional intent. As the Supreme Court stated in *Flood v. Kuhn*,⁷² “[i]f there is any inconsistency or illogic in all this, it is an inconsistency and illogic of long standing that is to be remedied by the Congress and not by this Court.”⁷³ Neither the statutory language nor the sparse legislative history provides a definitive answer to the problem. In the final analysis, public policy should control the question, and that policy clearly would be furthered by a more liberal interpretation of section 16(b).

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⁶⁹ 136 F.2d at 235.

⁷⁰ 404 U.S. at 424 (1972).

⁷¹ 15 U.S.C. § 78p(b) (1970).

⁷² 407 U.S. 258 (1972).

⁷³ *Id.* at 284.

