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## ARTICLES

### The Judicial and Regulatory Constriction of Section 16(b) of the Securities Exchange Act of 1934

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Insider trading, a hotly debated issue for several years,<sup>1</sup> has been the subject of vigorous Securities and Exchange Commission ("SEC") enforcement and criminal prosecution.<sup>2</sup> This "war"<sup>3</sup> has seen both its victories<sup>4</sup> and defeats<sup>5</sup> for the government. In many of these cases, the prosecution must rely on circumstantial evidence<sup>6</sup> and uncertain fiduciary duty principles.<sup>7</sup> This is largely due to the Supreme Court's decisions in *United States v. Chiarella*<sup>8</sup> and *Dirks v. SEC*<sup>9</sup> construing section 10(b) of the Securities Ex-

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1 The subject of insider trading (and its propriety) has been addressed at length. See, e.g., Dennis W. Carlton & Daniel R. Fischel, *The Regulation of Insider Trading*, 35 STAN. L. REV. 857 (1983); Robert J. Haft, *The Effect of Insider Trading Rules on the Internal Efficiency of the Large Corporation*, 80 MICH. L. REV. 1051 (1982); Henry G. Manne, *Insider Trading and the Law Professors*, 23 VAND. L. REV. 547 (1970); William K.S. Wang, *Trading on Material Nonpublic Information on Impersonal Stock Markets: Who Is Harmed, and Who Can Sue Whom Under SEC Rule 10b-5*, 54 S. CAL. L. REV. 1217 (1981).

2 See, e.g., *United States v. Carpenter*, 484 U.S. 19 (1987); *Dirks v. SEC*, 463 U.S. 646 (1983); *United States v. Chiarella*, 445 U.S. 222 (1980); *United States v. Chestman*, 947 F.2d 551 (2d Cir. 1991) (en banc); *SEC v. Clark*, 915 F.2d 439 (9th Cir. 1990); *United States v. Willis*, 737 F. Supp. 269 (S.D.N.Y. 1990); sources discussed in MARC I. STEINBERG & RALPH C. FERRARA, *SECURITIES PRACTICE: FEDERAL AND STATE ENFORCEMENT* §§ 2:07-15, 6:11 (1985 & Supp. 1992).

3 For a description of this "war" on insider trading, see DAVID A. VISE & STEVE COLL, *EAGLE ON THE STREET* 49 (1991) (referring to "the SEC's war on insider trading").

4 See, e.g., *United States v. Grossman*, 843 F.2d 78 (2d Cir. 1988); *United States v. Newman*, 664 F.2d 12 (2d Cir. 1981); *SEC v. Materia*, 745 F.2d 197 (2d Cir. 1984).

5 See, e.g., *Dirks v. SEC*, 463 U.S. 646 (1983); *United States v. Chiarella*, 445 U.S. 222 (1980); *SEC v. Switzer*, 590 F. Supp. 756 (W.D. Okla. 1984).

6 See, e.g., *SEC v. Switzer*, 590 F. Supp. 756 (W.D. Okla. 1984).

7 See, e.g., *United States v. Chestman*, 947 F.2d 551 (2d Cir. 1991) (en banc).

8 445 U.S. 222 (1980).

9 463 U.S. 646 (1983).

change Act of 1934.<sup>10</sup> Yet, unlike section 10(b), section 16 of the Securities Exchange Act deals explicitly with insider trading.<sup>11</sup> It is ironic that, at the same time that the SEC is vigorously pursuing alleged insider traders, it has relaxed the mandates of section 16, thereby making trading by certain insiders on confidential information more difficult to police.<sup>12</sup> Coupled with recent judicial decisions addressing section 16,<sup>13</sup> the SEC's conduct constricts the scope of this remedial statute.

Section 16(b) is an integral part of the regulatory framework enacted by Congress to proscribe the use of confidential information by corporate insiders in the trading of equity securities of their issuers.<sup>14</sup> Section 16 seeks to prevent such abuses of inside information by means of a threefold attack: First, section 16(a) requires certain insiders to file reports with the SEC of their equity security holdings and transactions in the issuer's securities;<sup>15</sup> second, section 16(c) prohibits such insiders from transacting short sales in the issuer's equity securities;<sup>16</sup> and, third, section 16(b) entitles the issuer or a security holder bringing suit on its behalf to recover "short-swing" profits derived from the purchase

10 15 U.S.C. § 78j(b) (1988).

11 *Id.* § 78p.

12 *See infra* Part III.

13 *See infra* Part I.

14 15 U.S.C. § 78p(b) (1988). *See* Ownership Reports and Trading by Officers, Directors and Principal Security Holders, Exchange Act Release No. 28,869 [1990-1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 84,709 (Feb. 8, 1991); S. REP. NO. 1455, 73d Cong., 2d Sess. 13 (1984).

15 *See* Interpretive Release on Rules Applicable to Insider Reporting and Trading, Exchange Act Release No. 18,114 [1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 26,062 (Sept. 24, 1981):

Section 16(a) of the Exchange Act provides that every person who is directly or indirectly the beneficial owner of more than ten percent of any class of equity security (other than an exempted security) registered pursuant to Section 12, or who is an officer or director of the issuer of such security, shall file with the Commission an initial report disclosing the amount of all equity securities of such issuer of which he is the beneficial owner . . . . If the registered security is also listed on a national securities exchange, such ownership reports must also be filed with the exchange.

*Id.* at 19,063-66. The filing of ownership reports pursuant to § 16 has been most recently updated in Ownership Reports and Trading by Officers, Directors and Principal Security Holders, *supra* note 14, ¶ 84,709.

As noted by Professor Louis Loss, these reports are readily available to the public both at the SEC and at the relevant exchange and are widely distributed by subscription. 2 LOUIS LOSS, SECURITIES REGULATION 1039 n.9 (2d ed. 1961). *See* Whittaker v. Whittaker Corp., 639 F.2d 516, 528 n.10 (9th Cir. 1981).

16 15 U.S.C. § 78p(c) (1988).

and sale (or sale and purchase) by a subject insider of such issuer's equity securities within a six month period.<sup>17</sup>

Under section 16(b), an irrebuttable presumption is created when "insiders" engage in such short-swing transactions. The profits<sup>18</sup> that the insider gained by the transactions are recoverable by an issuer that initiates a suit or, if it declines to do so, in a properly instituted shareholder's suit expressly authorized by the statute.<sup>19</sup> Moreover, intent to profit from a transaction that falls within the statute's scope is unnecessary for recovery.<sup>20</sup> According to the Seventh Circuit, as well as other courts, an insider is "deemed capable of structuring his dealings to avoid any possibility of taint and therefore must bear the risks of any inadvertent miscalcula-

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17 In its entirety, § 16(b) 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.

15 U.S.C. § 78p(b). There are certain exceptions to this general rule which are discussed elsewhere in this article.

18 In view of the statute's broad remedial nature, a strict formula for computing "profit realized" has been established. Such a formula is designed to "squeeze all possible profits out of stock transactions, and thus to establish a standard so high as to prevent any conflict between the selfish interest of a fiduciary officer, director, or stockholder and the faithful performance of his duty." *Smolowe v. Delendo Corp.*, 136 F.2d 231, 239 (2d Cir.), *cert. denied*, 320 U.S. 751 (1943). The formula established matches the lowest price in with the highest price out, thus ensuring recovery of all possible profits. *See, e.g., id.*; *Whittaker v. Whittaker Corp.*, 639 F.2d 516 (9th Cir. 1981); *Morales v. Consolidated Oil & Gas, Inc.*, [1982 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 98,796 (July 17, 1982).

19 *See* § 16(b), *supra* note 17.

20 *See, e.g., Allis-Chalmers Mfg. Co. v. Gulf & Western Indus.*, 527 F.2d 335, 347 (7th Cir. 1975), *cert. denied*, 424 U.S. 928 (1976).

tion."<sup>21</sup> The fact that an unwary party may inadvertently violate section 16(b) has been held to be within the statute's remedial scope.<sup>22</sup>

Despite judicial and regulatory recognition of Congress's intent to create a broad remedy combatting insider trading under section 16(b),<sup>23</sup> recent court decisions and SEC administrative rules have constricted the usefulness and availability of this remedy. This constriction of section 16(b) contravenes Congress's broad remedial purpose in enacting section 16(b). According to the Supreme Court, Congress intended to "curb the evils of insider trading [by] . . . taking the profits out of a class of transactions in which the possibility of abuse was believed to be intolerably great."<sup>24</sup> Moreover, the narrowing of the remedy provided in section 16(b) does not comport with the principle of construction enunciated by the Supreme Court in *Reliance Electric Co. v. Emerson Electric Co.*<sup>25</sup> There, the Court clearly set forth that "where alternative constructions of the terms of section 16(b) are possible, those terms are to be given the construction that best serves Con-

21 *Bershad v. McDonough*, 428 F.2d 693, 696 (7th Cir. 1970) (imposing strict liability upon a § 16 violator regardless of intent), *cert. denied*, 400 U.S. 992 (1971); *see also* *Whiting v. Dow Chemical Co.*, 523 F.2d 680, 687 (2d Cir. 1975) ("[T]he unwary who fall within [§ 16's] terms have no one but themselves to blame."); *Western Auto Supply Co. v. Gamble-Skogmo, Inc.*, 348 F.2d 736, 742 (8th Cir. 1965) (having inadvertently failed to structure the transaction(s) so as to avoid the strictures of § 16, such failure "subjects [the insider] to the disciplinary effect of § 16(b), regardless of the legitimate purpose for which the shares were destined").

22 *See, e.g.*, *Reliance Elec. Co. v. Emerson Elec. Co.*, 404 U.S. 418, 422 (1972) ("[C]ourts have recognized that the only method Congress deemed effective to curb the evils of insider trading was a flat rule taking the profits out of a class of transactions in which the possibility of abuse was believed to be intolerably great."). In *Bershad* the court stated:

In order to achieve its goals, Congress chose a relatively arbitrary rule capable of easy administration. The objective standard of Section 16(b) imposes strict liability upon substantially all transactions occurring within the statutory time period, regardless of intent of the insider or the existence of actual speculation. This approach maximized the ability of the rule to eradicate speculative abuses by reducing difficulties in proof. Such arbitrary and sweeping coverage was deemed necessary to insure the optimum prophylactic effect.

*Bershad*, 428 F.2d at 696.

*See* *Ownership Reports and Trading by Officers, Directors and Principal Security Holders*, *supra* note 14, ¶ 84,709. ("Section 16 is a strict liability provision under which an insider's profits can be recovered regardless of whether the insider actually was in possession of material, nonpublic information.")

23 *See supra* notes 21-22.

24 *Reliance*, 404 U.S. at 422.

25 404 U.S. 418 (1972).

gressional purpose of curbing short-swing speculation by corporate insiders."<sup>26</sup>

The recently promulgated SEC rules and judicial precedent impacting upon the parameters of section 16(b) are the focus of this article. First, this work will address the issue of standing to sue under section 16(b), focusing on the ramifications of the recent Supreme Court decision in *Gollust v. Mendell*<sup>27</sup> as well as other cases.<sup>28</sup> As will be seen, an allegedly aggrieved shareholder's standing to sue remains unresolved in a number of critical situations. Second, the applicable section 16(b) statute of limitations will be addressed. The statute, while providing that no suit may be commenced more than two years after the alleged short-swing trading,<sup>29</sup> leaves open the question whether equitable tolling principles apply.<sup>30</sup> In *Lampf v. Gilbertson*,<sup>31</sup> the Supreme Court, construing the statute of limitations under section 10(b) of the Exchange Act,<sup>32</sup> adopted a limitations period precluding the application of equitable tolling.<sup>33</sup> Hence, the important issue arises, which this aspect of the Article seeks to resolve, whether *Lampf's* rationale should be extended to section 16(b) actions. Third, the work will examine the SEC's treatment of derivative securities, such as stock options, under the section 16 regulatory framework. As will be discussed, the SEC, pursuant to its recent rule amendments,<sup>34</sup> exempts from coverage, after a six-month holding period, an insider's exercise of an option and the immediate sale of the underlying security.<sup>35</sup> This position leaves the door open for insider abuse and represents a rather ironic step for the Commis-

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26 *Id.* at 424. Not surprisingly, critics assert that § 16 is unduly broad, no longer necessary, and should be repealed. See, e.g., Marleen A. O'Connor, *Toward a More Efficient Deterrence of Insider Trading: The Repeal of Section 16(b)*, 58 *FORDHAM L. REV.* 309 (1989); William H. Painter, *How to Control Insider Trading*, A.B.A. J., March 1, 1987, at 38; S.S. Samuelson, *The Prevention of Insider Trading: A Proposal for Revising Section 16 of the Securities Exchange Act of 1934*, 25 *HARV. J. ON LEGIS.* 511 (1988).

27 111 S. Ct. 2173 (1991).

28 See *infra* notes 60-128 and accompanying text.

29 15 U.S.C. § 78p(b).

30 See *infra* Part III.

31 111 S. Ct. 2773 (1991).

32 15 U.S.C. § 78j(b).

33 *Lampf*, 111 S. Ct. at 2781. As will be discussed, the Court adopted a limitations period for § 10(b) actions of one year after discovery and in no event more than three years after the alleged violation. See *infra* notes 139-55 and accompanying text.

34 Ownership Reports and Trading by Officers, Directors and Principal Security Holders, *supra* note 14, ¶ 84,709.

35 See *infra* notes 156-99 and accompanying text.

sion to take in view of its declared "war" on insider trading. An even more puzzling SEC action is the subject of the Article's final Part, namely, the Commission's deletion from section 16's scope the purchase (or sale) by an individual before she becomes an officer or director and the subsequent offsetting transaction after such person attains insider status.<sup>36</sup> This position conflicts with every major court decision and raises issues relating to both the validity and wisdom of the SEC's action. Hence, during a time in which insider trading is being vigorously prosecuted by the government, the Commission has relaxed a number of rules in this area. The SEC's actions, in conjunction with the ramifications of certain recent Supreme Court and other decisions, present an opportunity to provide an in-depth analysis focusing on the viability of the section 16 framework from both a legal and policy perspective.

## I. STANDING TO SUE

### A. Introduction

Under section 16(b), the profits gained by an insider in a short-swing transaction are recoverable by the issuer in a suit initiated by it, or if it declines to do so, in a properly instituted security holder's suit expressly authorized by the statute.<sup>37</sup> Specifically, section 16(b) provides that the plaintiff must be the "owner of [a] security" of the "issuer" at the time the suit is "instituted."<sup>38</sup> Any "security," such as warrants, convertible debentures, bonds, puts, calls, and a variety of other financial instruments, will suffice to confer standing.<sup>39</sup> The "owner" of a security has been construed to include both record and beneficial owners.<sup>40</sup> The number of

36 See *infra* notes 200-42 and accompanying text.

37 15 U.S.C. § 78p(b). In part, § 16(b) provides that "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 . . . ." *Id.*

38 *Id.* See also § 16, *supra* note 17.

39 *Gollust v. Mendell*, 111 S. Ct. 2173 (1991); see also 16 ARNOLD S. JACOBS, SECTION 16 OF THE SECURITIES EXCHANGE ACT § 3.09[2] (1989).

40 JACOBS, *supra* note 39, § 3.09[2]; see also *Blau v. Lamb*, 314 F.2d 618 (2d Cir.), *cert. denied*, 375 U.S. 813 (1963); *Kogan v. Schulte*, 61 F. Supp. 604, 610 (S.D.N.Y. 1945).

Additionally, the plaintiff is not required to show that she owned stock in the issuer at the time the § 16 violation occurred. See *Blau v. Mission Corp.*, 212 F.2d 77 (2d Cir.), *cert. denied*, 347 U.S. 1016 (1954); *Blau v. Oppenheim*, 250 F. Supp. 881 (S.D.N.Y. 1966); see also *Gollust*, 111 S. Ct. at 2179-80 (plaintiff may have to show that he/she owned a security of the issuer at the time of the merger and filed a § 16 claim prior to such transaction in order to have standing under § 16(b)).

securities that must be owned to commence a section 16(b) action need only be minimal.<sup>41</sup> The construction of the term "issuer" in the phrase "the owner of any security of the issuer" has given rise to a host of standing issues under section 16(b).<sup>42</sup>

For example, in an arms-length merger, if the issuer of the subject securities is extinguished with the other corporation to the merger surviving, the question arises whether the surviving corporation or its security holders may step into the issuer's shoes and have standing to sue. A similar scenario occurs when a corporation is merged into the original issuer with the original issuer being the surviving corporation. On the other hand, if the subsidiary corporation is merged into the parent, the pertinent issue is whether the parent or its security holders may maintain a section 16(b) action.<sup>43</sup> Moreover, standing issues involving the construction of the term "issuer" occur in the triangular merger setting.<sup>44</sup> This common acquisition technique may implicate section 16(b) standing issues: namely, when an issuer whose stock is traded in violation of section 16(b) is merged into the subsidiary of another corporation and the issuer's stockholders receive shares in the parent corporation.<sup>45</sup> There are several possible plaintiffs in this situation: (1) the surviving corporation; (2) the parent; (3) a former security holder of the acquired corporation who now holds shares in the parent corporation; and (4) any security holder of

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41 JACOBS, *supra* note 39, § 3.09[2]; see also *Gollust*, 111 S. Ct. at 2179 (there is no restriction, for purposes of standing to sue to recover insider short-swing profits, in terms of either the number or percentage of shares or the value of such security that must be held by the plaintiff); *Portnoy v. Revlon, Inc.*, 650 F.2d 895 (7th Cir. 1981) (owner of one security permitted to bring § 16(b) action).

42 JACOBS, *supra* note 39, § 3.09[2]. A standing issue not discussed in the text arises when an issuer sells all or substantially all its assets. *Id.* According to Jacobs: "When an issuer sells all or substantially all of its assets, standing issues should be resolved as if the issuer merged into the purchasing entity." *Id.* § 3.04[5][c], 3.09[2]; see also *Kern County Land Co. v. Occidental Petroleum Corp.*, 411 U.S. 582 (1973).

43 An equally difficult issue is whether the parent and its security holders have standing to bring suit after the issuer is merged into its subsidiary.

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In a triangular merger the acquiring corporation creates a subsidiary, taking all of the subsidiary's stock in exchange for the amount of the acquiring corporation's stock that is to be transferred to the shareholders of the target corporation in the merger. The target is then merged into the new subsidiary, with the target's shareholders receiving, instead of shares in the subsidiary, as in an ordinary merger, shares of its parent, the acquiring corporation. The result is then that the subsidiary becomes the owner of the target's business.

LEWIS D. SOLOMON ET AL., *CORPORATIONS: LAW AND POLICIES* 947 (1982).

45 JACOBS, *supra* note 39, § 3.09[2].



the parent.<sup>46</sup> The United States Supreme Court's decision in *Gollust v. Mendell*<sup>47</sup> dealt with the construction of the term "issuer" under section 16(b) and will likely have a significant impact on these issues.

### B. *Gollust v. Mendell*

In *Gollust*, a stockholder of an issuer whose shares were traded in violation of section 16(b) initiated an action under section 16(b) for recovery of short-swing profits.<sup>48</sup> Subsequently, the issuer was merged into a shell corporation that was wholly owned by another entity ("the corporate parent").<sup>49</sup> The shareholders of the issuer, including the plaintiff, received stock in the corporate parent.<sup>50</sup> The Court expressly stated that the issue to be decided was whether a stockholder who had properly instituted a section 16(b) action could continue the action after a merger involving the issuer resulted in the exchange of the stockholder's interest in the issuer for stock in the issuer's new corporate parent.<sup>51</sup> The Court held, as long as the plaintiff owned a "security" of the "issuer" at the time the section 16(b) action is "instituted,"<sup>52</sup> standing exists.<sup>53</sup>

The *Gollust* Court further qualified its holding by requiring that the plaintiff security holder maintain some financial interest in the outcome of the litigation.<sup>54</sup> In this regard, the Court held that an adequate financial stake can be maintained when the plaintiff's interest in the issuer has been replaced by one in the issuer's new corporate parent.<sup>55</sup> The Court refused to read any further condition into the statute in order for standing to exist, other than the requirement that a section 16(b) plaintiff maintain

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46 *Id.*

47 111 S. Ct. 2173 (1991).

48 *Id.* at 2176. The action was initiated only after demand on the issuer was made and more than 60 days had passed without the issuer instituting the action.

49 *Id.*

50 *Id.* at 2176-77.

51 *Id.* at 2178.

52 *Id.* at 2179 (The Court defines "institute" to mean "inaugurate or commence; as to institute an action." (quoting BLACK'S LAW DICTIONARY 985-86 (3d ed. 1933)); see BLACK'S LAW DICTIONARY 800 (6th. ed. 1990) (same definition); RANDOM HOUSE UNABRIDGED DICTIONARY OF THE ENGLISH LANGUAGE 988 (2d ed. 1987) ("to set in operation; to institute a lawsuit.").

53 *Gollust*, 111 S. Ct. at 2179, 2181.

54 *Id.* at 2180-81. The Court stated that a § 16(b) claim could not be maintained by someone who is subsequently divested of any interest in the outcome of the litigation.

55 *Id.* at 2181.

a financial interest in the outcome of the litigation sufficient to motivate its prosecution and avoid constitutional standing difficulties.<sup>56</sup>

### C. Implications of *Gollust v. Mendell*

#### 1. Types of Transactions

##### a. Cash-out Mergers

At first glance it seems that the Court's decision in *Gollust* is broad; however, it actually may be quite limiting. First, the decision in *Gollust* evidently precludes security holders of an issuer involved in a cash-out merger from bringing suit under section 16(b).<sup>57</sup> This is because *Gollust* requires plaintiffs to maintain some continuing financial interest in the outcome of the litigation to have standing to sue under section 16(b).<sup>58</sup> Since security holders of the issuer who have been cashed-out do not have such a continuing financial interest, it follows that they do not have standing under section 16(b).<sup>59</sup>

The inequity of such a result is demonstrated in *Rothenberg v. United Brands Co.*<sup>60</sup> and *Portnoy v. Kawecki Berylco Industries.*<sup>61</sup> In *Rothenberg*, the plaintiff-shareholder filed a section 16(b) claim one day prior to the issuer being involved in a short-form cash-out merger.<sup>62</sup> The court held that the plaintiff must maintain standing as a shareholder throughout the litigation to bring a section 16(b) claim.<sup>63</sup> Granting the defendant's motion for summary judgment, the court reasoned that a non-shareholder, or one who

<sup>56</sup> *Id.*

<sup>57</sup> *Cf. Gollust*, 111 S. Ct at 2180-81. See also *supra* note 43.

<sup>58</sup> *Gollust*, 111 S. Ct at 2181 ("[A] Section 16[b] plaintiff [must] maintain a financial interest in the outcome of the litigation sufficient to motivate its prosecution and avoid constitutional standing difficulties.").

<sup>59</sup> See *Rothenberg v. United Brands Co.*, [1977-1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 96,045, at 91,690 (May 11, 1977) (shareholders entitled to receive in the issuer cash in a cash out merger have no continuing financial interest), *aff'd mem.*, 573 F.2d 1295 (2d Cir. 1977); JACOBS, *supra* note 39, § 3.09[2] ("[A] stockholder of an issuer whose shares have been converted upon consummation of a cash merger into the right to receive cash cannot continue to maintain a Section 16(b) suit, even if he has not surrendered his stock certificates.").

<sup>60</sup> *Rothenberg*, [1977-1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 96,045, at 91,690 (May 11, 1977) (plaintiff must maintain some continuing financial interest in the outcome of the litigation to have standing to sue under § 16(b)).

<sup>61</sup> 607 F.2d 765 (7th Cir. 1979).

<sup>62</sup> *Rothenberg*, [1977-1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) at 91,690.

<sup>63</sup> *Id.* at 91,691. The court felt that this requirement was implicit in the nature of any derivative action where the recovery will inure to the benefit of the corporation. *Id.*

loses his status as a shareholder during the course of the litigation because of a cash-out merger, can gain no possible advantage from a corporate recovery and should therefore be precluded from bringing suit under section 16(b).<sup>64</sup> Similarly, in *Portnoy*, the issuer was involved in a cash-out merger five days after the plaintiff-shareholder filed his section 16(b) claim.<sup>65</sup> Citing to *Rothenberg*, the court held that the plaintiff in a section 16(b) action must maintain his shareholder status throughout the pendency of the lawsuit, and that an action will abate if the plaintiff loses such status before the litigation ends.<sup>66</sup> Since after the cash-out merger the plaintiff in *Portnoy* had no such continuing interest, the court held that he lacked standing to bring the section 16(b) action.<sup>67</sup>

In denying the shareholder standing to sue under section 16(b), *Rothenberg* and *Portnoy* focused on whether the plaintiff would receive a personal financial benefit, either directly or indirectly (in terms of increased shareholder equity), upon the resolution of the suit. Holding that the plaintiffs had no personal interest in the claim after the cash-out merger, the courts in *Rothenberg* and *Portnoy* dismissed the plaintiffs' claims for lack of standing. This interpretation seems to comport with the literal language of the statute.<sup>68</sup>

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64 *Id.* at 91,692. The court stated: "To permit former shareholders to sue under Section 16(b) . . . allow[s] persons with no continuing financial interest in the outcome of litigation to constitute themselves the recipients of letters of marque and reprisal." *Id.*

65 *Portnoy*, 607 F.2d at 766.

66 *Id.* at 767. The court reasoned that a non-shareholder or one who loses interest during the course of the litigation may not pursue the litigation adequately. *Id.*

67 *Id.* In so holding, the court noted the severe nature of this decision: "[W]e consider the result in this case to have the appearance of being a harsh one in that a possible violation will apparently go uncorrected . . ." *Id.* at 769. The court, however, felt that the harshness of the decision was minimized since the plaintiff had not argued that the merger which cut off his standing was accomplished for the fraudulent purposes of avoiding enforcement of the § 16(b) claim. *Id.* This position is inconsistent with § 16(b) which holds violators strictly liable without regard to their subjective intent. *See, e.g., Serman v. Ferro Corp.*, 785 F.2d 162, 166 (6th Cir. 1986) ("Section 16(b) imposes a strict liability upon transactions coming within its parameters and this court has long recognized that consideration of issues such as motive, intent and the use or abuse of inside information is irrelevant in analyzing actions under its mandates."); *see also supra* notes 20-22.

68 Section 16(b) provides in pertinent part: "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 . . ." 15 U.S.C. § 78p(b) (1988). "Issuer" is defined in the statute as "any person who issues or proposes to issue any security." 15 U.S.C. § 78c(a)(8).

Nonetheless, when deciding standing issues under section 16(b), courts should also focus on the congressional intent underlying section 16(b). By ascertaining such intent, Congress's objectives in enacting the applicable statute will be effectuated. Limiting section 16(b)'s eligibility threshold to those with a continuing financial interest, as a precondition to bringing suit, appears contrary to section 16(b)'s rationale. Indeed, in making the shareholder's personal financial stake the key issue, such interest being often minimal at best and not the shareholder's key motivation, the courts are ignoring the purpose behind section 16(b).

Section 16(b) was enacted to provide a broad remedy to "curb the evils of insider trading [by] . . . taking the profits out of a class of transactions in which the possibility of abuse was believed to be intolerably great."<sup>69</sup> Allowing corporate insiders to avoid section 16(b) liability by using their leverage to induce a cash-out merger contradicts this purpose. If plaintiffs who objected to the merger<sup>70</sup> were allowed to continue their section 16(b) actions, insiders would be unable to so simply avoid section 16(b) liability, and congressional intent underlying section 16(b) would be furthered. While plaintiffs may not personally benefit from the section 16(b) recovery, the surviving corporation's recovery of the short-swing profits would be consistent with basic principles of unjust enrichment,<sup>71</sup> would cause disgorgement of the insider's ill-gotten profits, and would thereby dissuade further insider short-swing trading abuse.

#### b. *Arms-Length Mergers*

*Gollust* also may have implications in arms-length stock for stock mergers in which an issuer is merged into another corporation with the issuer's shareholders receiving stock of the surviving corporation. After *Gollust*, the question arises whether the shareholders of the issuer must have filed the section 16(b) action before the stock for stock merger occurred to have standing under section 16(b). To have standing, the Court in *Gollust* stated that

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69 *Foremost-McKesson Inc. v. Provident Sec. Co.*, 423 U.S. 232, 243 (1976).

70 Shareholders may object to the merger by perfecting a right to appraisal or, if there is no right to appraisal, by objecting in writing. REVISED MODEL BUSINESS CORP. ACT §§ 13.02, 13.20-28 (1984); SOLOMON ET AL., *supra* note 44, at 953-56. Such notification serves as proof that the shareholder maintains an adequate interest in being an adverse party.

71 See RESTATEMENT OF RESTITUTION § 1 (1937) ("A person who has been unjustly enriched at the expense of another is required to make restitution to the other.").

the plaintiff must be the "owner of [a] security of the issuer" at the time the suit is "instituted."<sup>72</sup> The Court adopted the dictionary definition of "instituted" which generally means to "inaugurate or commence: as to institute an action."<sup>73</sup> From the Court's language in *Gollust*, it appears that the shareholder receiving shares in the corporation into which the issuer is being merged must file suit before the merger to meet the "instituted" requirement as defined by *Gollust*. This is because the Court seems to exclude the corporation into which the issuer is being merged from the definition of "issuer" under section 16(b).<sup>74</sup> Therefore, under this construction, filing suit after the merger as a shareholder of the surviving corporation will not satisfy the standing requirements for a section 16(b) claim since the plaintiff will not be "instituting" a suit against the "issuer." Again, the Court's language in *Gollust* evidently narrows the parties who can bring section 16(b) claims and thwarts Congress's purpose in creating a broad remedy under section 16(b).

c. *Triangular Mergers and the Rights of a Surviving Corporation*

*Gollust* also may impact the triangular merger situation where a shareholder of the parent corporation seeks to bring a section 16(b) claim belonging to a corporation that has been merged into a subsidiary of the parent corporation. Moreover, the decision may impact on whether or not the surviving corporation itself has standing to bring the section 16(b) claims of the now defunct issuer which it has acquired. Based on language in *Gollust*, as will be elaborated upon below,<sup>75</sup> there may be relatively few instances in which section 16 may be enforced in the triangular merger context.

## 2. Analysis

Nonetheless, one must remember that the *Gollust* Court did not address these diverse situations. There, the Court was faced with a relatively narrow issue. Construing the statute in what it may have perceived in a remedial manner, the Court granted the

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72 *Gollust v. Mendell*, 111 S. Ct. 2173, 2176 (1991).

73 See *supra* note 52. The Court noted that Congress's intent in adopting this definition is corroborated by Congress's use of the word elsewhere to mean a commencement of an action. See, e.g., 8 U.S.C. § 1503(a) (1988) ("action . . . may be instituted only within five years after . . . final administrative denial"); 42 U.S.C. § 405(8)(g) (1988).

74 Cf. *Gollust*, 111 S. Ct. at 2179; see also *supra* notes 44-47 and accompanying text.

75 See *infra* notes 100-28 and accompanying text.

aggrieved plaintiff standing under section 16(b). Its language therefore may be confined to the case at bar and not viewed as a limitation to security holder standing in other situations where the granting of such standing would effectuate the statute's purpose. Given that a number of standing issues may remain open, lower court case law must be examined.

For example, in *Blau v. Oppenheim*,<sup>76</sup> a stockholder of the parent corporation was permitted to bring a section 16(b) claim on behalf of its subsidiary, into which the original issuer had been merged.<sup>77</sup> The plaintiff, Blau, never owned shares in the issuer and did not acquire shares in the parent until after the triangular merger.<sup>78</sup> The court reasoned that there was no shareholder in the original corporation to bring suit because the shares in the original issuer had been exchanged for shares in the parent. Hence, a holding that would allow only non-existing shareholders of the defunct issuer to bring suit would make section 16 unenforceable.<sup>79</sup> In order to carry out the purpose of section 16, the court broadly construed the term "issuer" to include the parent corporation.<sup>80</sup> This construction allows a parent and its security holders, even if they had not owned stock in the original issuer, to bring a section 16(b) claim.<sup>81</sup> This position, however, has been subject to disagreement.

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<sup>76</sup> 250 F. Supp. 881 (S.D.N.Y. 1966).

<sup>77</sup> *Id.* at 887. The plaintiff shareholder brought suit only after making demand on the parent corporation requesting that it or its wholly-owned subsidiary bring suit to recover the short-swing profits realized. With no reply and the statute of limitations about to run, the plaintiff filed the § 16(b) claim. *Id.* at 883.

<sup>78</sup> *Id.*

<sup>79</sup> *Id.* at 886-87. The court stated: "[T]he very act of dissolution of the issuer and the failure to bring suit by the date thereof would end the right of security holders to pursue the insider and have him disgorge his profits. This hardly conforms to the essential legislative policy of Section 16(b)." *Id.*

<sup>80</sup> *Id.* at 884. The court reasoned that while "section [16(b)] makes no reference to survivor or successor corporations of an issuer, . . . neither does it contain any bar against the maintenance of Section 16(b) suits by such corporations or their security owners. To deny them the right to maintain suit would serve to defeat the purpose of the law; to accord them the right serves to further it." *Id.* at 886.

<sup>81</sup> *Id.* The court noted that a holding that would allow only the shareholder of the defunct issuer to bring § 16(b) claims would "enable unscrupulous insiders to arrange a merger or its equivalent to thwart the recovery of short-swing profits under Section 16(b)." *Id.* at 887. Attacking this position, the defendant stated that courts have the power "to look beyond the form of a transaction conceived in fraud" and implied that the court should make such a determination on an ad hoc basis. *Id.* The court correctly discredited the defendant's argument stating that the examination of subjective standards based on "intent, lack of motive, or improper conduct" is exactly what § 16(b) sought to avoid. *Id.* See cases cited *supra* notes 20-22.

In *Lewis v. McAdam*,<sup>82</sup> for example, the Ninth Circuit reached a somewhat different conclusion. In *Lewis*, the plaintiff was a shareholder in the parent corporation. By means of a triangular merger, the parent's subsidiary had absorbed the issuer whose shares allegedly had been traded in violation of section 16.<sup>83</sup> The plaintiff in *Lewis*, like the plaintiff in *Blau*, never owned shares in the issuer and did not acquire shares in the parent until after the issuer merged into the subsidiary.<sup>84</sup> The Ninth Circuit in *Lewis* affirmed a summary judgment granted against the plaintiff-shareholder on the grounds that he did not have standing.<sup>85</sup> The court held that "where a corporation is merged out of existence by the wholly owned subsidiary of another corporation, the parent corporation is not an 'issuer' within the meaning of section 16(b)."<sup>86</sup> Similarly, the court held that a shareholder of the parent corporation was not an "owner of any security of the issuer" and accordingly lacked standing to institute a section 16(b) action.<sup>87</sup>

In contrast to *Blau*, the court in *Lewis* declined to construe the term "issuer" broadly.<sup>88</sup> Rather, the Ninth Circuit took what it felt was a more literal approach to interpreting section 16(b).<sup>89</sup> The court stated that the plain meaning of section 16(b) does not allow the parent corporation or shareholder thereof to be an "issuer."<sup>90</sup> The court felt that its holding that the surviving corpo-

82 762 F.2d 800 (9th Cir. 1985).

83 *Id.* at 801-02.

84 *Id.* at 802. (The plaintiff in *Lewis* brought suit only after demand was made and subsequently denied.)

85 *Id.* at 804.

86 *Id.* The court expressly rejected the decision in *Blau v. Oppenheim* which held that a "shareholder of a parent corporation may bring an action under Section 16(b) against the director of a company that has merged into a wholly owned subsidiary of the parent corporation." *Id.* at 803.

87 *Id.* at 804.

88 *Id.* at 803-04.

89 *Id.* The court stated:

The starting point for interpreting any statute is the plain meaning of the language used by Congress. Absent a clearly established legislative intent to the contrary, that language, if clear and unambiguous, will ordinarily be regarded as conclusive, since it is generally assumed that Congress expresses its purposes through the ordinary meaning of words it uses.

*Id.* at 804. The Supreme Court has agreed with this interpretation in the securities law context. See, e.g., *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976) (holding that scienter must be shown in private damage claims under § 10(b)).

90 An "issuer" of a security is defined under § 3(a)(8) of the 1934 Act as "any person who issues or proposes to issue any security . . ." 15 U.S.C. § 78c(8) (1988). The

ration in the merger was an "issuer" for section 16(b) purposes was adequate to effectuate the congressional purpose of providing an enforcement mechanism against short-swing insider trading under section 16(b).<sup>91</sup>

*Lewis* and similar cases<sup>92</sup> represent the lower courts' propensity to deny standing to a party with an attenuated interest in the section 16(b) claim so long as there is another party that has a less attenuated claim.<sup>93</sup> In drawing this distinction, however, the courts have failed to recognize that the party having the less attenuated interest is often an insider or an affiliate seeking to ensure that short-swing profits are not recovered. Hence, this judicial demarcation line makes little sense from a practical or policy perspective.

Section 16(b) states that an eligible plaintiff can bring a derivative section 16(b) claim "if the issuer shall fail or refuse to bring such suit within sixty days after request or shall fail diligently to

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court reasoned that: "Congress is well aware of the corporate practice of parent companies utilizing wholly owned subsidiaries in merger transactions. Had Congress wanted to discourage this practice by conferring standing on shareholders of a parent corporation whose wholly owned subsidiary absorbed the original issuing corporation, it knew how to do so." *Lewis v. McAdam*, 762 F.2d 800, 804 (9th Cir. 1985).

91 *Lewis*, 762 F.2d at 804. In *Portnoy v. Kawecki Berylco Indus.*, 607 F.2d 765 (7th Cir. 1979), the plaintiff-shareholder was denied standing to bring a § 16(b) claim because the issuer in which he owned stock had been involved in a cash-out merger. Alternatively, the plaintiff sought standing as the owner of securities in the parent corporation which was in turn the parent of the corporation into which the original issuer had been merged. The court dismissed the plaintiff's arguments which were based on the decision in *Blau*, holding that the statute was clearly written and the court could not rewrite the statute to include grandparent corporations within the definition of issuer for § 16(b) purposes. *Id.* at 768.

In *Portnoy*, the court distinguished *Blau* on the grounds that in *Blau* the issuer no longer existed, whereas in *Portnoy* the majority perceived that the issuer continued to exist as a wholly owned subsidiary of another corporation. The court stated that since the issuer itself along with its corporate shareholder could bring the § 16(b) action, there was a sufficient remedy available under the statute. The court, however, implied that if the issuer had been extinguished, as was the situation in *Blau*, a different result would be required. The statutory language would only allow the shareholders of a defunct issuer to bring a § 16(b) claim, giving rise to an "absurd result." Under this reasoning, no party would exist that would have standing to enforce the violation. *Id.* In this respect, the court's decision is puzzling since it appears that, in fact, the issuer ceased to exist as a corporate entity. *Id.* at 769 n.1 (Suygert, J., dissenting).

92 See, e.g., *Lewis v. McAdam*, 762 F.2d 800 (9th Cir. 1985); *Rothenberg v. United Brands Co.*, [1977-1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 96,045 (May 11, 1977), *aff'd without opinion*, 573 F.2d 1295 (2d Cir. 1977); *American Standard, Inc. v. Crane Co.*, 510 F.2d 1043 (2d Cir. 1974), *cert. denied*, 421 U.S. 1000 (1975); *Newmark v. RKO General, Inc.*, 425 F.2d 348 (2d Cir.), *cert. denied*, 400 U.S. 854 (1970).

93 See, e.g., *Lewis*, 762 F.2d at 801-02.



prosecute the same thereafter.<sup>94</sup> By so creating the private right of action under section 16(b), Congress sought to prevent interested insiders from impeding a suit's prosecution.<sup>95</sup> To facilitate a private litigant's cause of action, Congress eliminated certain procedural hurdles from section 16(b) litigation that exist in ordinary derivative suits. For example, under section 16(b) the security holder has the right to initiate a suit if the corporation declines to do so at the end of the sixty day period following demand.<sup>96</sup> Another procedural advantage to bringing a derivative action under section 16(b) is that, unlike a number of other claims under federal or state law that may be brought derivatively,<sup>97</sup> the independent directors of the corporation cannot cause dismissal of the section 16(b) claim pursuant to the business judgment rule.<sup>98</sup> Given the clear congressional objective in enacting section 16(b), it is disconcerting that some courts construe the statute in an unduly restrictive manner. By putting the section 16(b) claims back in the hands of interested affiliates while excluding private litigants who admittedly have an attenuated interest in the litigation, these courts ignore the congressional intent of section 16(b), which is to provide a broad and effective remedy to combat insider "short-swing" abuse.

The United States Supreme Court's decision in *Gollust v. Mendell*<sup>99</sup> may have a substantial impact on the standing issues presented in the foregoing cases. However, due to the distinct fact situations presented, the effect of the Supreme Court's decision in

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94 15 U.S.C. § 78p(b) (1988).

95 See JACOBS, *supra* note 39, § 3.01[1] ("Giving security holders the right to bring suit is important since corporate officers and directors might well be reluctant to sue a fellow officer or director.").

96 *Id.*

97 See, e.g., *Surowitz v. Hilton Hotels Corp.*, 383 U.S. 363 (1966) (derivative suit based on fraud allegedly committed by corporation's management); *Eisenberg v. Flying Tiger Line, Inc.*, 451 F.2d 267 (2d Cir. 1971) (derivative suit to enjoin the effectuation of a plan of reorganization and merger).

98 See, e.g., *Cramer v. General Tel. & Elec. Corp.*, 582 F.2d 259, 276 n.22 (3d Cir. 1978) (it is permissible for a security holder to bring a § 16(b) claim if the issuer has not brought suit by the end of the sixty day period following demand), *cert. denied*, 439 U.S. 1129 (1979); *Jones v. Freemont Energy Corp.*, 537 F. Supp. 300, 301 (D. Colo. 1982); *Colan v. Monumental Corp.*, 524 F. Supp. 1023, 1027-28 (N.D. Ill. 1981). The business judgment rule is a judicial principle that presumes propriety in a board's decision when certain conditions are met. See generally *Zapata Corp. v. Maldonado*, 430 A.2d 779 (Del. 1981); *Auerbach v. Bennett*, 393 N.E.2d 994 (N.Y. 1979); DENNIS J. BLOCK ET AL., *THE BUSINESS JUDGMENT RULE: FIDUCIARY DUTIES OF CORPORATE DIRECTORS* (3d ed. 1989).

99 111 S. Cl. 2173 (1991).

*Gollust* on the holdings in such cases as *Blau* and *Lewis* is not entirely clear. In *Blau* and *Lewis* the plaintiff-shareholders never owned shares in the original issuer. In *Gollust*, the plaintiff owned shares in the issuer and had instituted a section 16(b) action before the merger. To have standing under the literal language of *Gollust*, the plaintiffs in *Blau* and *Lewis* would have had to own a "security" of the "issuer" at the time they "instituted" the section 16(b) claim. The Court in *Gollust* stated that "[a]n 'issuer' of a security is defined under section 3(a)(8) of the 1934 Act as the corporation that actually issued the security . . . and does not include parent or subsidiary corporations."<sup>100</sup> If this language is followed in subsequent cases raising other standing issues, *Gollust* will be viewed as a restrictive decision because, by defining the term "issuer" to exclude the corporate parent, plaintiffs in a position like those in *Blau* and *Lewis* would be unable to bring a section 16(b) claim. Under the definition of "issuer," as set forth in *Gollust*, such security holders did not own a security of the "issuer" at the time the action was instituted. While the plaintiff in *Gollust* was allowed to continue the suit while it held shares only in the corporate parent, the Court appeared to attach great significance to the fact that the plaintiff had previously owned stock in the issuer and had initiated suit before the issuer's merger into the subsidiary. It may be argued that, based on language in *Gollust*, these conditions will have to be met before one can bring a section 16(b) cause of action.

By defining the term "issuer" as excluding a corporate parent for purposes of section 16(b), it appears that *Gollust* flatly rejects the holding in *Blau*. *Gollust* also can be viewed as disagreeing in part with the decision in *Lewis*<sup>101</sup> in that *Lewis* allowed the surviving subsidiary into which an issuer was merged to bring a section 16(b) claim.<sup>102</sup> The court in *Lewis* did not make a determination as to whether the corporation into which the issuer was merged was in fact an "issuer" as defined under section 16(b). Rather, due

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100 *Id.* at 2179.

101 The basis of the decision in *Blau* that allowed the plaintiff-shareholder of the corporate parent to bring a § 16(b) claim was that the parent was an "issuer" for § 16(b) purposes. See *Blau v. Oppenheim*, 250 F. Supp. 881, 887 (S.D.N.Y. 1966). This position is contrary to the language contained in *Gollust*, stating that a corporate parent is not an "issuer" for purposes of § 16(b). *Gollust*, 111 S. Ct. at 2179. The decision in *Lewis* concurs with *Gollust* that a corporate parent is not an "issuer" for § 16(b) purposes. *Lewis v. McAdam*, 762 F.2d 800, 804 (9th Cir. 1985).

102 *Lewis*, 762 F.2d at 803.

to the absence of federal law on whether a surviving corporation can bring suit under section 16(b), the court in *Lewis* examined state law to determine whether the surviving subsidiary into which the issuer was merged inherits the original issuer's section 16(b) cause of action.<sup>103</sup> The court held that the section 16(b) cause of action was a property right, and that under the applicable common law, as codified by New York law, all property rights automatically vest in the surviving corporation after a merger.<sup>104</sup> Therefore, the court held that the surviving subsidiary corporation was vested with the rights to initiate the section 16(b) action.<sup>105</sup> This authorized the surviving subsidiary to act in the issuer's stead for section 16(b) purposes.<sup>106</sup>

In response to *Lewis*' adoption of state law principles to ascertain the parameters of the section 16(b) right of action, one may point to language in *Gollust* that a subsidiary is not considered an "issuer" for section 16(b) purposes.<sup>107</sup> Since the *Gollust* Court's language requires that one be considered an "issuer" or security holder thereof to have standing to bring suit under section 16, the decision in *Lewis*, allowing the subsidiary into which the issuer is merged to bring suit, is arguably contradicted by *Gollust*.

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103 *Id.* at 802. The court stated that: "A cause of action under section 16(b) arises from breach of an insider's statutory duty and is designed to safeguard property rights." *Id.* at 803.

104 *Id.* The court restated the common law rule as: "[F]ollowing a merger, a chose in action to enforce a property right vests in the surviving corporation and no right of action remains in the extinct corporation." *Id.* See also *Western Auto Supply Co. v. Gamble-Skogmo, Inc.*, 348 F.2d 736 (8th Cir. 1965), *cert. denied*, 382 U.S. 987 (1966).

105 *Lewis*, 762 F.2d at 803.

106 *Id.* The decision in *Lewis* disallowing the parent and its shareholders who had not owned shares in the original issuer from bringing suit was based on the premise that the surviving subsidiary corporation would be able to bring the action and that this was sufficient to effectuate the congressional purpose of providing an enforcement mechanism under § 16(b). If the surviving corporation into which the issuer is merged does not have standing under § 16(b) to bring a claim, which arguably is the case based on the language of *Gollust*, the premise in *Lewis* for disallowing the parent corporation and its shareholders to bring suit is faulty. It appears that language contained in *Gollust* only permits a party owning a "security" of the "issuer" at the time the action is "instituted" to have standing to sue under § 16(b). In defining these terms, the Supreme Court arguably excludes the surviving subsidiary, issuer, parent and the parent's shareholders from bringing a § 16(b) claim because they did not own shares in the issuer and/or initiate the § 16(b) action before the merger. This being the case, there may not be an adequate enforcement mechanism for § 16(b) violations.

107 *Gollust v. Mendell*, 111 S. Ct. 2173, 2179 (1991) ("An 'issuer' of a security is defined under § 3(a)(8) of the 1934 Act as the corporation that actually issued the security . . . and does not include parent or subsidiary corporations.").

The better interpretation of *Gollust*, however, is that it merely excludes the surviving corporation from bringing a section 16(b) claim on the basis that such an entity is not an "issuer" under section 16(b). The Court leaves open the question of whether the surviving corporation can bring the action based on its status as a legal successor in interest. In fact, courts other than *Lewis* have allowed the surviving corporation to bring the acquired issuer's section 16(b) cause of action under state law principles.<sup>108</sup> In *American Standard, Inc. v. Crane Co.*,<sup>109</sup> for example, the Second Circuit held that, while a corporation into which the original issuer is merged is not an "issuer" as defined under section 16(b), the surviving corporation is a legal successor in interest and has standing to bring section 16(b) claims belonging to the acquired corporation.<sup>110</sup> The court held that the surviving corporation brings such claims as a successor to claims already matured, as a chose in action of the acquired corporation.<sup>111</sup>

This analysis is consistent with predecessor-successor merger principles.<sup>112</sup> Moreover, several United States Supreme Court decisions, which have looked to state law principles to ascertain the parameters of the federal securities laws, provide support. For example, in *Chiarella v. United States*,<sup>113</sup> the Court held that silence, absent a duty to disclose, does not give rise to liability under section 10(b) and SEC Rule 10b-5.<sup>114</sup> The Court examined

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108 See, e.g., *Lewis*, 762 F.2d at 803; *American Standard, Inc. v. Crane*, 510 F.2d 1043, 1062 (2d Cir. 1974); *Newmark v. RKO General, Inc.*, 425 F.2d 348, 348 (2d Cir. 1970).

109 510 F.2d 1043, 1062 (2d Cir. 1974).

110 *Id.* at 1062.

111 *Id.* The court stated: "While a legal successor in interest, indeed, has standing to recover, it does so only as successor to a claim already matured, a chose in action of the acquired corporation." *Id.*

112 See, e.g., REVISED MODEL BUSINESS CORP. ACT § 11.06. The Annotation provides that "[o]n the effective date every disappearing corporation that is a party to the merger dissolves into the surviving corporation and the surviving corporation automatically becomes the owner of all real and personal property and becomes subject to all liabilities, actual or contingent, of each disappearing corporation." 3 MODEL BUS. CORP. ACT. ANN. § 11.06 at 1287 (3d ed. 1991).

113 445 U.S. 222 (1980). This case involved an employee of a financial printer who, gained access to nonpublic information relating to takeover bids derived from materials sent by prospective bidders to his employer. The employee deduced the names of the target and acquiring companies which were to be included in the document at a later time. The defendant purchased stock in the target companies and sold the shares immediately after the takeover attempts were made public.

114 *Id.* at 230-33 (the use of nonpublic information is not a fraud under § 10(b) unless the person has an affirmative duty to disclose such information before trading).

state law principles to determine whether such a duty exists.<sup>115</sup> Finding that, as the jury was charged, no such duty existed under state law, the Court held that Chiarella did not violate Rule 10b-5 by trading on inside information.<sup>116</sup> In *Dirks v. SEC*,<sup>117</sup> the Supreme Court once again examined state law principles to determine whether a duty to disclose material nonpublic information existed under the federal securities laws.<sup>118</sup> In *Dirks*, as in *Chiarella*, the Court examined the state law fiduciary relationship between shareholders and corporate insiders.<sup>119</sup> The Court held that "a tippee assumes a fiduciary duty to the shareholders of a corporation . . . only when the insider has breached his fiduciary duty to the shareholders . . . and the tippee knows or should know that there has been a breach."<sup>120</sup> In *Santa Fe Industries v. Green*,<sup>121</sup> the Supreme Court held that claims based solely on the

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115 *Id.* at 229-32.

116 *Id.* at 231-35. The Court held that no duty to disclose existed because the defendant in *Chiarella* had no relationship with the companies or their shareholders whose securities he traded. *Id.* at 232-33. Moreover, the defendant was not a fiduciary or a person in whom the sellers had placed their trust and confidence. *Id.* The Court did not address the misappropriation issue, namely that Chiarella breached a duty to his employer and his employer's clients, because the jury was not adequately charged. *Id.* at 235-37. After *Chiarella*, the lower federal courts have given their approbation to the misappropriation theory. *See, e.g.*, *SEC v. Cherif*, 933 F.2d 403 (7th Cir. 1991); *SEC v. Clark*, 915 F.2d 439 (9th Cir. 1990); *Rothberg v. Rosenbloom*, 771 F.2d 818 (3d Cir. 1985); *United States v. Willis*, 737 F. Supp. 269 (S.D.N.Y. 1990); *SEC v. Peters*, 735 F. Supp. 1505 (D. Kan. 1990); *United States v. Elliot*, 711 F. Supp. 425 (N.D. Ill. 1989); *see also* *Carpenter v. United States*, 484 U.S. 19 (1987) (Supreme Court evenly divided on the misappropriation issue at bar). *But see* *United States v. Chestman*, 947 F.2d 551 (2d Cir. 1991) (en banc) (refusal to apply misappropriation theory under circumstances of case in family relationship context). *See generally* Douglas M. Branson, *Discourse on the Supreme Court Approach to SEC Rule 10b-5 and Insider Trading*, 30 EMORY L.J. 263 (1981); Donald C. Langevoort, *Insider Trading and the Fiduciary Principle: A Post-Chiarella Restatement*, 70 CAL. L. REV. 1 (1982); Wang, *supra* note 1.

117 463 U.S. 646 (1983).

118 *Id.* at 646. "*Dirks* dealt with the duty of a tippee to disclose or abstain from trading or tipping when he or she possesses material nonpublic information." (quoting syllabus).

119 *Id.* at 661-62.

120 *Id.* at 660. The intent of the insider must be to benefit, directly or indirectly, from the disclosure in order for a breach of the duty to shareholders to exist. Such benefit may be shown by the insider's receipt of pecuniary gain or reputational enhancement that will translate into future earnings. The requisite showing also may be made by the insider making a gift of confidential information to the tippee. Without this motive for personal gain, disclosure of material nonpublic information will not violate rule 10b-5. *Id.* at 660-61. *See generally* Bruce A. Hiler, *Dirks v. SEC—A Study in Cause and Effect*, 43 MD. L. REV. 292 (1984); Richard M. Phillips, *Insider Trading Liability After Dirks*, 16 REV. SEC. REG. 841, 848 (1983).

121 430 U.S. 462 (1977).

fairness of transactions or internal mismanagement are best relegated to state law.<sup>122</sup> More recently, in *Kamen v. Kemper Financial Securities*,<sup>123</sup> the Court relied on state law to construe the demand on director requirement in derivative litigation under the federal securities laws.<sup>124</sup>

Given that the Supreme Court has often looked to state law principles in ascertaining the parameters of the federal securities laws,<sup>125</sup> in this instance the Court should acknowledge the surviving corporation as the legal successor in interest under state law principles. Interpreting *Gollust* in this manner reaches a more flexible result: The section 16(b) cause of action that otherwise would have been extinguished continues to exist in the surviving corporation. This result, however, will only have practical importance where the surviving corporation and its parent, if one exists, are unaffiliated with the original issuer. This will not alleviate the harsh result in cases where the surviving corporation is an affiliate of the party who committed the section 16(b) violation.<sup>126</sup>

Moreover, in the triangular merger situation, as represented by *Lewis* and *Blau*, shareholders generally bring suit only after their demand on the parent corporation (into whose wholly owned subsidiary the original issuer has been merged) has been denied or ignored.<sup>127</sup> Giving the surviving subsidiary the right to bring the section 16(b) suit will not change the outcome in these cases since the parent, which wholly owns the subsidiary, has al-

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122 *Id.* at 477-80. See Ralph C. Ferrara & Marc I. Steinberg, *A Reappraisal of Santa Fe: Rule 10b-5 and the New Federalism*, 129 U. PA. L. REV. 263 (1980).

123 111 S. Ct. 1711 (1991).

124 *Id.* at 1713, following *Burks v. Lasker*, 441 U.S. 471 (1979) (Court looked to state law to determine whether the disinterested directors of a registered investment company have the power to terminate a properly brought action based on violations of the Investment Company Act and the Investment Advisers Act). In *Kamen* the Court opined:

[W]here a gap in the federal securities laws must be bridged by a rule that bears on the allocation of governing powers within the corporation, federal courts should incorporate *state law* into federal common law unless the particular state law in question is inconsistent with the policies underlying the federal statute.

*Id.* at 1713 (emphasis in original) (quoting syllabus).

125 See, e.g., cases cited *supra* notes 113-24.

126 See, e.g., *Lewis v. McAdam*, 762 F.2d 800 (9th Cir. 1985); *Blau v. Oppenheim*, 250 F. Supp. 881 (S.D.N.Y. 1966).

127 See *Lewis*, 762 F.2d at 802 (the board of directors rejected the demand on the ground that it would be unseemly and contrary to the parent's best interests); *Blau*, 250 F. Supp. at 883 (plaintiffs' demand, that the parent or its wholly owned subsidiary bring the § 16(b) claim, was left unanswered).

ready declined to bring the claim. The formal acknowledgment of the surviving corporation's ability to bring the section 16(b) claim therefore is often of cosmetic, not practical, value. To truly effectuate congressional intent in creating a broad remedy under section 16(b), and prevent unjust enrichment, the courts should authorize such section 16(b) claims to be instituted by security holders of the parent corporation. Doing so would thwart attempts by affiliated insiders to preclude section 16(b) causes of action by simply influencing the surviving corporation's board of directors to refuse the demand to bring the claim.

#### D. Conclusion

The decision in *Blau* appears to best effectuate the congressional purpose of section 16 by allowing the subsidiary into which the issuer is merged and the corporate parent and its shareholders, who never owned securities in the issuer, to bring suit for section 16(b) violations. While not fully carrying out the statute's objective by excluding corporate parents and their shareholders from bringing section 16(b) claims, the decision in *Lewis*, at least when the acquiring company is unaffiliated with the insiders committing the section 16(b) violation, provides some remedy against section 16 violations by allowing the subsidiary into which the issuer was merged to bring suit under state law principles. However, the decision in *Lewis* does not go far enough because it does not impede insiders who commit section 16(b) violations and who are affiliated with the acquiring corporation from influencing the acquiring corporation's board of directors to refuse demand, thereby precluding the section 16(b) cause of action.

After the decision in *Gollust*, it is possible that only a shareholder of the issuer who filed her section 16(b) claim prior to the merger may be able to invoke the statute on behalf of the defunct issuer.<sup>128</sup> The Supreme Court's language in *Gollust* thus may exclude the subsidiary, parent, and the parent's shareholders from suing under section 16(b). The Supreme Court's language in *Gollust*, which narrowly refers to parties having standing to sue under section 16(b), contravenes the congressional purpose underlying section 16(b).

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<sup>128</sup> In a cash-out merger, it appears that security holders, even if they institute the § 16(b) suit prior to the merger, are precluded from continuing with the action. See *supra* notes 99-108 and accompanying text.

Significantly, by interpreting the *Gollust* decision as leaving open the question of whether a surviving corporation inherits the causes of action possessed by the corporation that was acquired, the harsh outcome that would otherwise result is lessened. However, to truly effectuate Congress's purpose in creating a broad remedy under section 16(b), the statute should be flexibly construed to put causes of action for the recovery of short-swing profits back into the hands of private litigants. This approach would prevent affiliated insiders from controlling such causes of action by way of their influence on the board of directors of the acquiring corporation.

The confusion surrounding section 16(b) standing issues, which is heightened by the decision in *Gollust*, should be clarified by congressional action. A statute addressing section 16(b) standing issues should clearly define the parties able to bring suit in the various situations discussed herein. Such a statute would provide a definitive expression of congressional intent on this issue while reducing the possibility that *Gollust* will be narrowly construed to exclude plaintiffs upon whom Congress may well have intended to confer standing under section 16(b).

## II. STATUTE OF LIMITATIONS

The applicable statute of limitations for section 16(b) actions provides that "no such suit shall be brought more than two years after the date such profit was realized."<sup>129</sup> In regard to whether tolling of the limitations period is permitted, three positions have been advanced: (1) the two-year period runs strictly from the time the profits were realized, without any tolling;<sup>130</sup> (2) the two-year period is tolled until the corporation had sufficient information to put it on notice of its potential section 16(b) claim;<sup>131</sup> and (3) the "disclosure rationale," namely, that the two-year period is tolled until the insider discloses the transactions at issue by filing the required section 16(a) reports.<sup>132</sup> These positions have arisen

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129. 15 U.S.C. § 78p(b) (1988); see *supra* note 17, quoting § 16(b) of the Securities Exchange Act.

130. See *Morales v. Mylan Lab.*, 443 F. Supp. 778 (W.D. Pa. 1978); *Chambliss v. Coca-Cola Bottling Corp.*, 274 F. Supp. 401 (E.D. Tenn. 1967), *aff'd*, 414 F.2d 256 (6th Cir. 1969), *cert. denied*, 397 U.S. 916 (1970); *Blau v. Lamb*, 191 F. Supp. 906 (S.D.N.Y. 1961); *Carr-Consolidated Biscuit Co. v. Moore*, 125 F. Supp. 423 (M.D. Pa. 1954).

131. See *Whittaker v. Whittaker Corp.*, 639 F.2d 516, 527 (9th Cir.) (not adopting standard but setting forth its existence), *cert. denied*, 454 U.S. 1031 (1981).

132. *Id.* at 527-30; *Shattuck Denn Mining Corp. v. La Morte*, [1973-1974 Transfer Bind-



due to the silence of both the statute and legislative history on the tolling issue.<sup>133</sup>

In determining whether a strict or flexible interpretation of section 16(b)'s limitations period is ultimately adopted, the judiciary's principal focus should be on congressional intent.<sup>134</sup> In *Whittaker v. Whittaker Corp.*,<sup>135</sup> the Ninth Circuit opted for the "disclosure" rationale, reasoning that, "examining the legislative purpose of Section 16 as a whole and considering the place of the time provision in that overall legislative scheme, we infer that tolling of the two year time period is required when the pertinent Section 16(a) reports are not filed."<sup>136</sup> On the other hand, the district court in *Chambliss v. Coca-Cola Bottling Corp.*<sup>137</sup> adhered to a strict interpretation of the limitations period stating that "[t]he Court is aware of no authority which would justify the [assertion] that Congress, when it established limitations periods in the federal securities acts . . . , intended that such limitations periods be 'tolled' under circumstances such as those presented here."<sup>138</sup> These decisions represent the diverse positions that the lower courts have espoused in ascertaining congressional intent on the tolling issue.

The United States Supreme Court's recent decision in *Lampf v. Gilbertson*<sup>139</sup> resolved the applicable limitations period for section 10(b) claims.<sup>140</sup> In its decision, the Court deciphered congressional intent on the tolling issue under the one-year/three-year limitations structure provided for in the 1933 and 1934 Acts.<sup>141</sup>

er] Fed. Sec. L. Rep. (CCH) ¶ 94,429, at 95,472 (March 8, 1974); *Blau v. Albert*, 157 F. Supp. 816 (S.D.N.Y. 1957); *Grossman v. Young*, 72 F. Supp. 375 (S.D.N.Y. 1947).

Under § 16(a) and SEC rules thereunder, insiders are required to file reports disclosing their ownership interest in equity securities of the issuer and in any change thereof. See Ownership Reports and Trading by Officers, Directors, and Principal Security Holders, *supra* note 14.

133 See *Whittaker*, 639 F.2d at 528; *Grossman*, 72 F. Supp. at 378.

134 See, e.g., *Whittaker*, 639 F.2d at 527; *Chambliss*, 274 F. Supp. at 411; *Carr-Consolidated Biscuit Co.*, 125 F. Supp. at 432; *Grossman*, 72 F. Supp. at 378. See generally *Virginia Bankshares, Inc. v. Sandberg*, 111 S. Ct. 2749, 2763 (1991) ("[T]he rule that has emerged . . . is that recognition of any private right of action for violating a federal statute must ultimately rest on congressional intent to provide a private remedy.").

135 639 F.2d 516, 527 (9th Cir.), *cert. denied*, 454 U.S. 1031 (1981).

136 *Id.* at 528.

137 274 F. Supp. 401 (E.D. Tenn. 1967), *aff'd*, 414 F.2d 256 (6th Cir. 1969), *cert. denied*, 397 U.S. 916 (1970).

138 *Id.* at 411.

139 111 S. Ct. 2773 (1991).

140 15 U.S.C. § 78j(b) (1988).

141 *Lampf*, 111 S. Ct. at 2781.

This construction may have an impact on the applicability of the doctrine of equitable tolling to the two year limitations period provided for in section 16(b).

The Supreme Court's decision in *Lampf* may be construed to support the theory that the two year period runs strictly from the period in which the profits were realized, without any tolling. In *Lampf*, the Court held that equitable tolling is not available with respect to actions brought under section 10(b) of the Securities Exchange Act.<sup>142</sup> Because section 10(b) itself does not contain a statute of limitations, the Court opted for the one-year/three-year statute of limitations contained in various provisions of the 1933 and 1934 Acts.<sup>143</sup> In particular, the Court chose the period specified in section 9(e) of the Exchange Act.<sup>144</sup> More importantly for the discussion in the present context, the Court held that the one-year/three-year structure is fundamentally inconsistent with the equitable tolling doctrine.<sup>145</sup>

The Court pointed out that "[t]he one year period, by its terms, begins after discovery of the facts constituting the violation,

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142 *Id.* at 2781-82.

143 *Id.* at 2781. Under the one-year/three-year scheme as provided in § 9(e) of the Exchange Act, the cause of action must be brought within one year after the discovery of the facts constituting the violation and, in any event, within three years after such violation. Before the decision in *Lampf*, a number of courts applied the general rule to § 10(b) that if Congress fails to provide a statute of limitations for a federal cause of action, the court will use the local state time limitation most analogous to the case at hand. See, e.g., *Breen v. Centex Corp.*, 695 F.2d 907 (5th Cir. 1983). In *Lampf*, the court held that there was no reason to look to state law to determine the statute of limitations under § 10(b) because Congress has provided an express limitations period for correlative remedies within the Securities Acts. *Lampf*, 111 S. Ct. at 2782.

144 *Lampf*, 111 S. Ct. at 2782 n.9. The Court chose § 9(e) of the 1934 Act as the language to govern the standard for an action under § 10(b). The Court was required to make such a choice because the language of the various one-and-three-year provisions contained in the 1933 and 1934 Acts differ slightly in terminology. *Id.* In this regard, § 13 of the Securities Act provides the limitations period for alleged violations of §§ 11 and 12 of that Act. With respect to §§ 11 and 12(2), actions must be initiated within one year after the facts constituting the violation were known or *should have been known* to the plaintiff and in no event more than three years after the alleged violation. 15 U.S.C. § 77m (1988) (emphasis added). Hence, it appears that, for the one year period to begin running for § 10(b) limitations purposes, the plaintiff must have actual knowledge. As the Court stated: "To the extent that these distinctions in the future might prove significant, we select as the governing standard for an action under section 10(b) the language of section 9(e) of the 1934 Act." *Lampf*, 111 S. Ct. at 2782 n.9.

145 *Lampf*, 111 S. Ct. at 2782.

making tolling unnecessary."<sup>146</sup> With respect to the three year limit, the Court reasoned that this period is one of repose and therefore is inconsistent with tolling.<sup>147</sup> Hence, the Court concluded that Congress intended that the three year limitation serve as the final cutoff, thereby precluding equitable tolling during this period.<sup>148</sup>

It may be asserted that the statute of limitations applicable to section 16(b) establishes an outside limit, a period of two years, much like the three year outside limit under the one-year/three-year structure. The analysis utilized in *Lampf* provides support for the proposition that the Supreme Court would hold that Congress intended to establish two years as a final cutoff for a section 16(b) cause of action and that the doctrine of equitable tolling would not apply.

The one-year/three-year structure, as represented by section 9(e), provides that no action shall be maintained unless brought within one year after the discovery of the facts constituting the violation and "within three years after such violation."<sup>149</sup> As discussed above, the Supreme Court in *Lampf* determined that the three year outside limit under the one-year/three-year scheme clearly served as a cutoff, with no tolling principles applicable to this period.<sup>150</sup> Turning to section 16(b), that provision's language states that no action shall be brought "more than two years after the date such profit was realized."<sup>151</sup> The similarity in language setting forth the outside limit of both the section 16(b) and the one-year/three-year statutes could result in the Supreme Court construing the section 16(b) limitations period not to be subject

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146 *Id.*

147 *Id.*, quoting Harold S. Bloomenthal, *The Statute of Limitations and Rule 10b-5 Claims: A Study in Judicial Lassitude*, 60 U. COLO. L. REV. 235, 288 (1989) ("[T]he inclusion of the three-year period can have no significance in this context other than to impose an outside limit.").

148 *Lampf*, 111 S. Ct. at 2782. The Court appears to adopt the position of the ABA Committee on Federal Regulation of Securities, that there is an "inescapable conclusion that Congress did not intend equitable tolling to apply in actions under the securities laws." *Id.* at 2782 (quoting the ABA COMMITTEE ON FEDERAL REGULATION OF SECURITIES, REPORT OF THE TASK FORCE ON STATUTE OF LIMITATIONS FOR IMPLIED ACTIONS 645, 655 (1986)).

149 15 U.S.C. § 78i(e) (1988). Section 9(e) of the 1934 Act provides: "No action shall be maintained to enforce any liability created under this section, unless brought within one year after the discovery of the facts constituting the violation and within three years after such violation." 15 U.S.C. § 78i(e) (1988).

150 *Lampf*, 111 S. Ct. at 2782.

151 *See* 15 U.S.C. § 78p(b).

to the doctrine of equitable tolling, as it did the one-year/three-year scheme. Nonetheless, critical distinctions can be drawn that call for a result in favor of equitable tolling under section 16(b).

The statutory construction of the one-year/three-year scheme lends itself more to an interpretation that the outside limit is an absolute, than does the two year limitation period under section 16(b). The one-year/three-year scheme, as opposed to the two year structure under section 16(b), has two elements: (1) the three year limitation from the time the cause of action accrues;<sup>152</sup> and (2) a one year limitation from actual discovery of the facts giving rise to the action.<sup>153</sup> Since the one year limitation period takes tolling into consideration and the three year outside limit does not, it can be asserted that by negative implication Congress did not intend that the three year outside limit be subject to tolling. On the other hand, while the section 16(b) limitations period sets an outside limit, it does not by its terms take tolling into consideration as does the one-year/three-year framework. This distinction makes section 16(b) more susceptible to an interpretation that the doctrine of equitable tolling applies to the two year limitations period provided therein.

More fundamentally, section 16(b) logically affords a remedy that presumes that the subject insider timely filed the reports mandated by the section. To permit an insider to violate section 16(a) by neglecting its filing obligation and thereby avoid section 16(b) liability for otherwise proscribed trades conflicts with the congressional objective of deterring insider abuse in the short-swing trading context. In *Lampf*, the Supreme Court apparently recognized the incompatibility of the section 16(b) limitations period with that of section 10(b): "Because [section 16(b)] requires the disgorgement of unlawful profits and differs in focus from Section 10(b) and from the other express causes of action, we do not find Section 16(b) to be an appropriate source from which to borrow a limitations period here."<sup>154</sup> When presented with the issue, the judiciary should recognize that the converse also is true and that the period of limitations applicable to section 10(b), and the unavailability of tolling thereunder, is equally incompatible with the purpose and policy of section 16. At the very

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152 The three-year period "accrues" upon the occurrence of the events giving rise to the § 10(b) violation. See *Lampf*, 111 S. Ct. at 2782.

153 See, e.g., 15 U.S.C. § 78i(e).

154 *Lampf*, 111 S. Ct. at 2780 n.5.

least, due to the differences in statutory language and countervailing policy rationales, the Supreme Court's decision in *Lampf* should be construed to leave open the issue whether the doctrine of equitable tolling applies to actions brought under section 16(b).

Considering the construction of the two statutory schemes along with the congressional objectives underlying section 16, the courts should adopt the disclosure approach which allows for a tolling period until such time as section 16(a) reports are accurately filed.<sup>155</sup> By adopting this approach, the courts can avoid the unwanted effect of subjecting potential defendants to the never ending threat of litigation so long as they fulfill their section 16(a) duties. Allowing subject defendants to successfully raise the statute of limitations defense when they have failed to comply with section 16(a) would thwart Congress's objectives in enacting that provision.

### III. THE SEC'S TREATMENT OF DERIVATIVE SECURITIES

Prior to the 1991 section 16 rule changes, the treatment of the grant and exercise of options and other derivative securities for purposes of section 16(b) was relatively settled.<sup>156</sup> Courts uniformly held that the exercise of an ordinary<sup>157</sup> option or other derivative security and the subsequent sale of the underlying security were a purchase and sale matched for purposes of section 16(b).<sup>158</sup> At the same time, courts deemed the original grant or

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155 This was the position adopted in *Whittaker v. Whittaker Corp.*, 639 F.2d 516, 527 (9th Cir.), *cert. denied*, 454 U.S. 1031 (1981). Moreover, if § 16(a) reports are inaccurately filed, the statute of limitations should be tolled under the common law doctrine of fraudulent concealment until such time as proper disclosure is made. *Id.* at 527 n.9. See *Blau v. Albert*, 157 F. Supp. 816, 819 (S.D.N.Y. 1957) (quoting Donald C. Cook & Myer Feldman, *Insider Trading Under the Securities Exchange Act (Part I)*, 66 HARV. L. REV. 385, 413 (1953)).

156 JACOBS, *supra* note 39, § 3.04[5][e].

157 If the grant of an option is merely a device being used to conceal the transfer of an underlying security, the courts have held the grant of the option to be a purchase of the underlying security, which is subject to § 16(b). *Id.*; see, e.g., *Bershad v. McDonough*, 428 F.2d 693 (7th Cir. 1970), *cert. denied*, 400 U.S. 992 (1971).

158 See, e.g., *Colan v. Monumental Corp.*, 713 F.2d 330 (7th Cir. 1983); *Morales v. Mapco, Inc.*, 541 F.2d 233 (10th Cir. 1976), *cert. denied*, 429 U.S. 1053 (1977); *Silverman v. Landa*, 306 F.2d 422 (2d Cir. 1962); *Blau v. Ogsbury*, 210 F.2d 426 (2d Cir. 1954). As stated by one commentator:

[T]he most usual situation leading to Section 16(b) liability, involves exercise of an employee stock option (under current law, such an exercise constitutes a purchase for Section 16(b) purposes), and the subsequent sale of those shares,

acquisition of the option a nonevent having no section 16(b) implications.<sup>159</sup> Prior to the 1991 section 16(b) rule changes, the SEC also maintained this position.<sup>160</sup>

The Commission, however, perceived that treating the acquisition of a derivative security as a nonevent under section 16(b) rendered the applicability of that statute to certain transactions involving derivative securities questionable.<sup>161</sup> Citing the uncertainty surrounding the application of section 16(b) to transactions in derivative securities under its former rules and existing case law, the SEC in 1991 adopted a new regulatory framework to govern derivative securities.<sup>162</sup> Under the new regulatory framework, the grant or acquisition of a derivative security is considered a purchase for section 16 purposes, with the exercise or conversion of the derivative security being a nonevent for purposes of section 16.<sup>163</sup> This approach reverses the SEC's previous regulatory approach and differs from cases that have held that the exercise of the option (rather than its acquisition) is the purchase of an equity security under section 16(b).<sup>164</sup> While restricting the ability of insiders to utilize inside information in transactions involving derivative securities, the new regulatory framework increases the potential for abuse of confidential information by insiders in ordinary transactions involving the option's exercise followed by the immediate sale of the underlying securities.

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at a higher price, within six months.

It is surprising that so many Section 16 insiders are 'torpedoed' by that scenario. Assuming that such persons do not knowingly self-destruct, we can only conclude that these persons did not know about Section 16(b). We can further conclude that the corporate issuer of the stock in question has not set up an effective pre-clearance system to prevent its Section 16 insiders from self-destructing.

Robert A. Barron, *Some Comments on Current Questions Under Section 16(b) of the Securities Exchange Act of 1934*, 18 SEC. REG. L.J. 194, 195 (1990).

159 See, e.g., *Colan v. Monumental Corp.*, 713 F.2d 330 (7th Cir. 1983); *Morales v. Mapco, Inc.*, 541 F.2d 233 (10th Cir. 1976), *cert. denied*, 429 U.S. 1053 (1977); *Silverman v. Landa*, 306 F.2d 422 (2d Cir. 1962); *Blau v. Ogsbury*, 210 F.2d 426 (2d Cir. 1954).

160 See *Ownership Reports and Trading by Officers, Directors and Principal Security Holders*, *supra* note 14, at 81,258 (portions of this section outlining the new regulatory framework are reproduced from this release).

161 *Id.* at 81,260. The specifics of these transactions are discussed *infra* notes 170-72.

162 See *Ownership Reports and Trading by Officers, Directors and Principal Security Holders*, *supra* note 14, at 81,258.

163 17 C.F.R. § 240.16b-6(a), (b) (1991).

164 See, e.g., *Colan v. Monumental Corp.*, 713 F.2d 330 (7th Cir. 1983); *Morales v. Mapco, Inc.*, 541 F.2d 233 (10th Cir. 1976), *cert. denied*, 429 U.S. 1053 (1977); *Silverman v. Landa*, 306 F.2d 422 (2d Cir. 1962).

The ambiguity of the prior SEC rules and judicial precedent regarding the applicability of section 16(b) to certain transactions involving derivative securities led the SEC to establish the new regulatory scheme.<sup>165</sup> In establishing this framework, the Commission seemed primarily concerned with three types of transactions:<sup>166</sup> First, the transaction in which an insider purchases an option and then, within a six-month period, instead of exercising the option sells stock in the corporation he otherwise held;<sup>167</sup> second, the situation in which an insider purchases options and subsequently sells the options within a six-month period;<sup>168</sup> and third, the situation in which an insider buys stock in the corporation and then buys put options.<sup>169</sup> Since prior SEC rules did not address these situations, the applicability of section 16(b) to these transactions before promulgation of the 1991 rules was problematic. Moreover, many courts did not match transactions in derivative securities with transactions in underlying securities for short-swing profit purposes.<sup>170</sup> Under the new regulatory framework, however, these transactions will be matched for short-swing profit purposes.

#### A. 1991 Regulatory Scheme

For the first time, the term "derivative security" is defined for purposes of section 16(b). This definition is used extensively in determining whether a particular transaction is subject to section 16(b). Rule 16a-1(c) generally defines the term "derivative security" as "any option, warrant, convertible security, stock appreciation

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165 Adoption of Amendments to Reporting and Trading Standards, Exchange Act Release No. 28,869 [1990-1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 84,709, at 81,260 (Feb. 8, 1991).

166 Cf. Ownership Reports and Trading by Officers, Directors and Principal Security Holders, *supra* note 14, at 81,259.

167 *Id.* at 81,260.

168 *Id.*

169 *Id.* In establishing the new regulatory scheme for derivative securities, the Commission was not concerned with the situations in which an insider purchases and sells stock within a six-month period or purchases an option, exercises the option and then sells the stock all within a six-month period. The profit would have been recoverable from the insider in these two situations. *Id.*

170 *Id.* The well established judicial principle that the grant or acquisition of an option or other derivative security is a nonevent under § 16(b) results in the exclusion of many of the derivative security transactions from § 16(b). See, e.g., Colan v. Monumental Corp., 713 F.2d 330 (7th Cir. 1983); Morales v. Mapco, Inc., 541 F.2d 233 (10th Cir. 1976); Silverman v. Landa, 306 F.2d 422 (2d Cir. 1962); Blau v. Ogsbury, 210 F.2d 426 (2d Cir. 1954); see also JACOBS, *supra* note 39, § 3.04[5][e].

right [SAR], or similar right with an exercise or conversion privilege at a price related to an equity security, or similar securities with a value derived from the value of an equity security . . . ."<sup>171</sup> If a particular transaction falls within the definition of derivative security, it will be subject to the new regulatory framework. This framework characterizes the acquisition and disposition of derivative securities as events that are matchable against other security transactions characterized as events in which the insider engaged.<sup>172</sup>

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171 17 C.F.R. § 240.16a-1(c) (1991).

Exclusions from the definition of "derivative security" include, but are not limited to:

- (1) rights of a pledgee of securities to sell the pledged securities; (2) rights of all holders of a class of securities of an issuer to receive securities pro rata, or obligations to dispose of securities, as a result of a merger, exchange offer, or consolidation involving the issuer of the securities; (3) securities that may be redeemed or exercised only for cash and do not permit the receipt of equity securities in lieu of cash, if the securities either: (i) are awarded pursuant to an employee benefit plan satisfying the provisions of § 240.16b-3(c); or (ii) may be redeemed or exercised only upon a fixed date or dates at least six months after award, or upon death, retirement, disability, or termination of employment; (4) interests in broad-based index options, broad-based index futures, and broad-based publicly traded market baskets of stocks approved for trading by the appropriate federal governmental authority; (5) interests or rights to participate in employee benefit plans of the issuer; or (6) rights with an exercise or conversion privilege at a price that is not fixed.

*Id.* § 240.16a-1(c)(1)-(6) (1991). If the transaction falls outside the definition of derivative security, only the purchase or sale of the underlying security will be considered an event for purposes of § 16(b). *Id.*

172 Ownership, Reports and Trading by Officers, Directors and Principal Security Holders, *supra* note 14, at 81,260.

Under the 1991 regulatory framework, acquisitions of call derivative securities from an issuer or third party are deemed purchases for purposes of § 16 and are matchable with any disposition of the underlying security (or other call equivalent position related to the same class of underlying security) for purposes of short-swing profit recovery. Likewise, acquisitions of put equivalent positions are matchable with any acquisition of the related underlying security (or any disposition of a put equivalent position related to the same class of underlying securities). Derivative securities which contain a floating exercise price are deemed to be acquired when the purchase price of the underlying security becomes due. If the timing of the event fixing the price is outside the control and knowledge of the holder, then the acquisition would be reportable as of the date of the event fixing the price. Such an acquisition would be exempt from § 16(b) matching with sales occurring before the fixing of the exercise price, but would not be exempt from § 16(b) matching with sales occurring thereafter. *Id.* at 81,264-65.

Dispositions of derivative securities are reportable events representing changes in beneficial ownership of the underlying securities, as well as in the derivative securities themselves, and are therefore subject to the short-swing profit recovery provisions of § 16(b). Dispositions of call derivative securities are matchable with any acquisition of related underlying securities (or other call equivalent position related to the same class of



### B. *Implications of the New Regulatory Scheme*

The concept that a derivative security is the functional equivalent of its underlying security for the purposes of section 16 forms the basis for the new regulatory framework.<sup>173</sup> For section 16 purposes, the SEC felt that the functional equivalent of derivative securities and their underlying equity securities required that the acquisition of the derivative securities, not the exercise, be deemed the significant event.<sup>174</sup> The SEC attributed little importance to the exercise of the option based on the belief that the exercise of a derivative security merely changes the form of beneficial ownership from indirect to direct.<sup>175</sup>

The SEC felt that the former regulatory scheme, which treated the exercise rather than the grant of the derivative security as the significant event for section 16(b) purposes, left open a significant potential for short-swing profit abuse in trading derivative securities.<sup>176</sup> By matching transactions in options, convertible se-

underlying securities). Likewise, dispositions of put equivalent positions are matchable with any disposition of related underlying securities (or call equivalent positions related to the same class of underlying securities). *Id.* at 81,266.

The rules also address § 16's effect upon expiration of derivative securities and option exercises as a result of a merger. The rules make clear that the expiration or cancellation without value of a long derivative security is exempt from § 16(b). However, the rules provide that the expiration of a short derivative security position may yield a profit which is subject to recovery under § 16(b). The exemption for option exercises that existed under the former rules has been deleted in the 1991 rule changes. The exemption is no longer necessary because the exercise of the option is exempt if it is not out-of the money. *Id.*

173 *Id.* at 81,258. The theory underlying this position is that the value of the derivative security is a functional equivalent of or related to the value of the underlying security. *Id.*

174 The SEC felt that the "[f]ailure to recognize that derivative securities are functional equivalents of the underlying securities for Section 16 purposes could permit insiders to evade disgorgement of short-swing profits simply by buying call options and selling the underlying stock, or buying underlying stock and buying put options." *Id.*

175 The Commission stated that:

the exercise of a derivative security, much like the conversion of a convertible security, essentially changes the form of beneficial ownership from indirect to direct. Since the exercise represents neither the acquisition nor the disposition of a right affording the opportunity to profit, it should not be an event that is matched against another transaction in the equity securities for purposes of Section 16(b) short-swing profit recovery.

*Id.* at 81,259.

176 The Commission stated:

Just as an insider's opportunity to profit commences when he purchases or sells the issuer's common stock, so too the opportunity to profit commences when

curities, warrants and similar derivative securities, the SEC hoped to curb the potential for short-swing profits in derivative securities.

While the SEC's new regulatory framework will likely reduce short-swing profits generated in derivative security transactions, it does so at a cost. The cost of the new regulatory structure is increased opportunity for abuse in the traditional derivative security transaction in which a grant of an option is given, the option is exercised, and the underlying security is sold. The increased potential for abuse under the new regulatory scheme comes from the ability of insiders to exercise options and sell the underlying securities immediately, as long as the option has been held for at least six months. This essentially allows insiders, subject to the securities acts' antifraud provisions, to freely trade in the corporation's securities after holding the option for a six-month period. For example, upon learning of bad news, an insider holding the derivative security for six months can immediately exercise the option and sell the underlying securities before such information is made public, thereby taking advantage of nonpublic information for his or her personal gain. Section 16 was enacted to prevent this type of transaction.<sup>177</sup>

### C. *The Regulatory Scheme's Conflict with Judicial Precedent*

An additional problem with the SEC's new regulatory framework is that it directly contradicts existing judicial precedent on this issue. The underlying assumption of the 1991 regulatory framework is that the grant of a derivative security constitutes a purchase for purposes of section 16(b). However, as previously discussed, the overwhelming majority of case law holds that the grant of a derivative security is a nonevent, not matchable against other purchases and sales under section 16(b).<sup>178</sup> Without this underlying assumption, the entire regulatory framework seems to

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the insider engages in transactions in options or other derivative securities that provide an opportunity to obtain or dispose of the stock at a fixed price.

*Id.* at 81,258.

177 See Comments made by U.S. Senator Carl Levin, Fed. Sec. L. Rep. (CCH) No. 1485, at 7 (Feb. 5, 1992) (The SEC's "rule change means that by the time a CFO is eligible to exercise an option, the six-month period is 'long gone' and the CFO can buy and sell immediately.").

178 See, e.g., *Colan v. Monumental Corp.*, 713 F.2d 330 (7th Cir. 1983); *Morales v. Mapco, Inc.*, 541 F.2d 233 (10th Cir. 1976); *Silverman v. Landa*, 306 F.2d 422 (2d Cir. 1962); *Blau v. Ogsbury*, 210 F.2d 426 (2d Cir. 1954).

unravel. Convincing the judiciary to adopt the view that the exercise of a derivative security is an exempt transaction under section 16(b) may prove problematic. Specifically, difficulty may arise in convincing judges that the receipt of an option is equivalent to the purchase of the underlying securities and that the actual receipt of the securities upon exercise of the option is not.<sup>179</sup>

The Second Circuit in *Greene v. Dietz*<sup>180</sup> criticized an option exercise exemption contained in former rule 16b-3.<sup>181</sup> Rule 16b-3 exempted option exercises of stock acquired pursuant to certain types of employee benefit plans.<sup>182</sup> In dicta, the court stated that the exemption of the option exercise contained in rule 16b-3 was inconsistent with the congressional purpose underlying section 16.<sup>183</sup> In criticizing the exemption of option exercises, the court

179 Peter I. Romeo & Alan L. Dye, *The New Section 16 Regulatory Scheme*, 24 REV. SEC. & COMM. REG. 112 (1991).

180 247 F.2d 689 (2d Cir. 1957).

181 The Second Circuit did not invalidate the rule, but merely criticized the rule in dicta as inconsistent with the purposes and policies underlying § 16(b). *Id.* at 694 ("Indeed, although not essential to our opinion, we express doubt as to the power of the Commission to promulgate Rule [16b-3]"). The court was not required to decide the validity of rule 16b-3 since it merely affirmed the trial court's decision on the issue of the defendant's good faith and exculpability in relying on § 23(a). Section 23(a) provides in pertinent part that:

No provision of this title imposing any liability shall apply to any act done or omitted in good faith in conformity with a rule, regulation, or order of the Commission . . . notwithstanding that such rule, regulation, or order may thereafter be amended or rescinded or determined by judicial or other authority to be invalid for any reason.

*Id.*

182 *See id.* at 691. In pertinent part, rule 16b-3 read as follows:

Any acquisitions of shares of stock or nontransferable options (other than convertible stock or stock acquired pursuant to a transferable option, warrant or right) by a director or officer of the issuer of such stock shall be exempt from the operation of Section 16(b) of the Act if the stock or option was acquired pursuant to a bonus, profit-sharing, retirement or similar plan meeting all of the following conditions . . . .

*Id.*

183 *Id.* at 693. The court recognized that it is the Commission's duty to promulgate regulations that are consistent with the expressed purpose of the controlling statute. *Id.*; *see Smolowe v. Delendo Corp.*, 136 F.2d 231, 240 (2d Cir. 1943) ("[t]he delegation serves no other than the commendable functions of relieving the statute from imposing undue hardship and giving it flexibility in administration"). Moreover, the court stated:

[I]ndeed, although not essential to our opinion, we express doubt as to the power of the Commission to promulgate Rule [16b-3] inasmuch as the Rule's broad language may permit acts by insiders sought to be prevented by the Securities Exchange Act. Nor do we regard the promulgation of the Rule as a matter solely within the expertise of the SEC and therefore beyond the scope of

discussed the fact situation above in which an insider takes advantage of inside information by utilizing his ability to exercise the option and immediately sell.<sup>184</sup> The court felt that the exemption of option exercises would allow insiders to take advantage of nonpublic information too easily by immediately exercising their options and selling their underlying securities upon learning of bad news.<sup>185</sup> Hence, according to the court, by requiring insiders to hold their underlying securities for six months after they have exercised their derivative securities would better serve the underlying purposes of section 16(b).<sup>186</sup>

District courts addressing rule 16b-3, after the decision in *Greene*, have disagreed on the validity of the rule. In *Pertman v. Timberlake*,<sup>187</sup> the district court, following the reasoning in *Greene*, found that rule 16b-3 was invalid and outside the SEC's rulemaking authority.<sup>188</sup> The court in *Pertman* agreed with *Greene* that rule 16b-3, which exempted the exercise of the option from section 16(b), directly conflicted with the congressional intent

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judicial review.

*Id.* at 692.

184 *Id.*

185 *Id.*

186 *Id.* The court stated that:

It would seem to us that such an opportunity for profit-taking by insiders in a temporary and artificially stimulated market would be minimized, in accord with the purpose of section 16(b), by a requirement that insiders who acquire corporate stock by the exercise of employee options pursuant to an [employee benefit] plan must retain their stock for at least six months after its acquisition or, in event of their failure to do so, must account to the corporation for the profits resulting from the sale thereof.

*Id.* at 693.

187 172 F. Supp. 246 (S.D.N.Y. 1959).

188 *Id.* at 251. The version of rule 16b-3 considered in *Greene* was amended prior to the decision in *Pertman*. *Id.* However, the rule was substantially the same after the amendments and the changes did not play a part in the court's decision in *Pertman*. *Id.*

The court in *Pertman* considered the criticism of rule 16b-3 in *Greene* to be merely dicta. *Id.* at 253. However, the court treated it as a holding. *Id.* ("I conclude that although the logical effect of the expression of doubt of the Court of Appeals for practical purposes is that of a holding, it was deliberately given the status of judicial dictum by the Court."). The court in *Pertman* felt that the *Greene* court's expression of doubt as to the validity of § 16(b) followed by the discussion of congressional purposes underlying § 16(b) presupposed the invalidity of rule 16(b). Moreover, the question of good faith would not have had to be answered had the court in *Greene* believed that rule 16b-3 was valid. Had the defendant in *Greene* not acted in good faith, the Second Circuit would have invalidated rule 16b-3. *Id.* The court in *Pertman*, however, reserved the right to consider the issue of the validity of rule 16b-3 and reached its own decision based on an independent consideration of the question. *Id.*

underlying section 16(b).<sup>189</sup> The *Perlman* court went further than the Second Circuit in *Greene* which merely criticized the rule, by invalidating the rule altogether.<sup>190</sup> In *Perlman*, the court stated: "What started out as a rule [rule 16b-3] to relieve from hardship has by constant expansion resulted in a pro tanto repeal of section [16(b)] with respect to restricted option stock."<sup>191</sup> Such repeal by regulation, implication, or judicial inventiveness, reasoned the court, "is not favored especially on so important a piece of legislation."<sup>192</sup> In *Perlitz v. Continental Oil*,<sup>193</sup> however, the court reached the contrary result, upholding rule 16b-3's exemption of an option's exercise.<sup>194</sup> Disagreeing with the decisions in *Greene* and *Perlman*, the court in *Perlitz* felt that the SEC acted reasonably in promulgating rule 16b-3 and that no proof had been offered to show that an increased danger of insider trading would materialize.<sup>195</sup> Therefore, the court chose to validate the rule.<sup>196</sup>

In its 1991 release, the SEC attempted to address the threatening precedent established in *Greene* and *Perlman*. The Commission reasoned that the exemption of the exercise criticized in those decisions was not part of a uniform regulatory scheme governing derivative securities as is the exemption in the 1991 scheme.<sup>197</sup> Accordingly, the SEC asserted that the rule considered in *Greene* and *Perlman* was adopted without the corollary ap-

189 *Id.* at 258 ("[W]e hold that Rule [16b-3] is in conflict with the expressed purpose of the statute"). The *Perlman* court stated that the function of the SEC is to carry out the legislative intent as it is clearly expressed in the statute. *Id.* However, the court went on to say that the ultimate enforcement of § 16(b) is left to the courts and not to the Commission and that "judicial review and action may always be had when the statutory and constitutional authority for the Commission's action is absent and when it has abused its powers . . ." *Id.* at 254.

190 *Id.* ("[W]e hold that Rule [16b-3] is in conflict with the expressed purpose of the statute and therefore invalid").

191 *Id.* at 257.

192 *Id.*

193 176 F. Supp. 219 (S.D. Tex. 1959).

194 *Id.* at 221; see also *Gruber v. Chesapeake & Ohio Ry. Co.*, 158 F. Supp. 593, 606 (N.D. Ohio 1957) (upholding the validity of rule 16b-3).

195 *Perlitz*, 176 F. Supp. at 227. The *Perlitz* court felt that the courts in *Greene* and *Perlman* did not give due deference to the SEC's interpretation of § 16(b). *Id.* at 223-27. The *Perlitz* court stated, that by delegating rulemaking authority to the SEC, "[T]he Congress has expressed its confidence in the ability and integrity of the Commission in carrying out the mandates thus entrusted to it." *Id.* at 223.

196 *Id.* In 1960, the SEC deleted the exemption which was contained in rule 16b-3 for stock acquired upon the exercise of options, warrants or rights. General Rules and Regulations, Securities Exchange Act of 1934, 25 Fed. Reg. 4902 (1960).

197 Ownership Reports and Trading by Officers, Directors and Principal Security Holders, *supra* note 14, at 81,263.

plication of short-swing profit liability to transactions in derivative securities.<sup>198</sup> In addition, the new SEC rules recognize that derivative securities are functionally equivalent to underlying equity securities for purposes of section 16.<sup>199</sup>

Unlike the SEC, court decisions thus far generally have declined to recognize that derivative securities are functionally equivalent to underlying securities for purposes of section 16. If the courts refuse to adopt the basis of the SEC's new regulatory scheme by continuing to treat the exercise of derivative securities as a purchase (rather than the grant of the option) for purposes of section 16(b), the SEC's new regulatory framework may fail. However, by promulgating a uniform regulatory framework for derivative securities, the SEC appears to have improved its chances of obtaining judicial acceptance of the new regulatory framework.

#### IV: THE SEC'S WAR ON INSIDER TRADING: GIVING AWAY A CROWN JEWEL

##### A. Introduction

The SEC has declared "war" on insider trading;<sup>200</sup> yet, at the same time, the Commission is on a mission to restrict the parameters of section 16. In section 16(b) cases, unlike those brought under section 10(b), an insider is held strictly liable for transactions falling within the purview of the statute.<sup>201</sup> To prove a section 16 violation, there is no requirement that circumstantial evidence or the insider's intent be examined.<sup>202</sup> Yet, the SEC fails to make optimal use of this statute. In the 1991 amendments to the section 16 rules, the SEC deemed pre-insider transactions by officers and directors normally to be outside the scope of section 16. The Commission's reasons for narrowing the applicability of

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198 *Id.*

199 *Id.*

200 See VISE & COLL, *supra* note 3, at 49. Shortly after Chairman John Shad's arrival at the SEC, he asserted that the Commission "was about to 'come down with hobnail boots' on illegal insider trading." *Id.* at 53.

201 See *Arrow Distrib. Corp. v. Baumgartner*, 783 F.2d 1274, 1281 (5th Cir. 1986) ("[N]either actual use of insider information nor intention to exploit such information is required to establish Section 16(b) liability."); *Sterman v. Ferro Corp.*, 785 F.2d 162, 166 (6th Cir. 1986) ("Section 16(b) imposes a strict liability upon transactions coming within its parameters and this court has long recognized that consideration of issues such as motive, intent and the use of or abuse of inside information is irrelevant in analyzing actions under its mandates.").

202 *Arrow Distrib. Corp.*, 783 F.2d at 1281; *Sterman*, 785 F.2d at 166.

section 16 are unclear, particularly while in a state of "war" on insider trading. The focus of this section is the SEC's newly adopted position exempting pre-insider transactions by officers and directors from section 16, and the policy implications flowing therefrom.

When an officer or director makes offsetting trades within a period of less than six months, the section 16 reporting and short-selling profit liability rules apply.<sup>203</sup> Section 16 reporting and liability exposure also arises when one of the trades occurs at the time of insider status and when the matching transaction occurs after termination of insider status.<sup>204</sup> Where, however, one of the trades takes place before the officer or director assumes insider status, the applicability of section 16 is less certain.

*B. 1991 Rule Changes and the SEC's  
Shift in Policy*

The section 16 rule amendments, promulgated in 1991, reflect a dramatic change in SEC policy on the issue of pre-insider trades by officers and directors. Prior to the 1991 amendments, the Commission required officers or directors to disclose trades which were conducted prior to becoming an insider.<sup>205</sup> In particular, former rule 16a-1(d) (which has now been replaced by rule 16a-2(a)) required officers and directors to disclose all trades conducted six months prior to attaining insider status.<sup>206</sup> The rule's objective was to dissuade officers and directors from taking advantage of information gained upon becoming an officer or director; therefore, transactions engaged in while acting as an officer or director were offset by transactions made shortly before attaining such insider status.<sup>207</sup> In the release proposing the 1991 rule changes, it appeared that the Commission would continue to effectuate this policy. Rule 16a-2(a), as proposed, would have required officers

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203 See JACOBS, *supra* note 39, § 3.03.

204 17 C.F.R. § 240.16a-2(b) (1991); *see, e.g.*, *Lewis v. Mellon Bank*, 513 F.2d 921, 924 (3d Cir. 1975); *Feder v. Martin Marietta Corp.*, 406 F.2d 260, 262-63 (2d Cir. 1969), *cert. denied*, 396 U.S. 1036 (1969) (transactions by officers after they cease to hold office are subject to § 16 if executed within six months of a transaction that occurred while that officer was an insider).

205 See former rule 16a-1(d), 17 C.F.R. § 240.16a-1(d) (1990).

206 *Id.*

207 Ownership Reports and Trading by Officers, Directors and Principal Stockholders, Exchange Act Release No. 26,333, [1988-1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 84,433, at 89,602. (Dec. 2, 1988) (proposing release).

and directors to disclose all trades conducted in the six-month period prior to attaining insider status.<sup>208</sup>

In adopting the 1991 rule amendments, however, the Commission, with little explanation, abandoned long-standing policy.<sup>209</sup> In the release, the Commission was persuaded by the comments submitted that the disclosure of officer and director transactions prior to attaining insider status should no longer be required. Subjecting those persons to liability, the SEC reasoned, even though they may not have known at the time of the transaction that they would become officers and directors in the future, was unduly harsh.<sup>210</sup> Therefore, rule 16a-2(a) provides, with one major exception,<sup>211</sup> that transactions occurring prior to the date a person becomes an officer or director are not subject to the reporting and liability provisions of section 16.<sup>212</sup> The SEC's change of position not only conflicts with its prior policy but also with the overwhelming case law on this issue, dating back more than thirty years.

### C. Case Law

In light of section 16(b)'s statutory language requiring that a ten percent beneficial owner be such, both at the time of the "purchase and sale, or the sale and purchase, of the security,"<sup>213</sup> it may be argued, by negative implication, that an officer or director must be such at the time of only one such transaction. This position has been adopted by all major courts that have addressed this issue.<sup>214</sup> As the First Circuit opined in a relatively recent decision: "[A]n officer or director need only hold the position at the

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208 *Id.*

209 Ownership Reports and Trading by Officers, Directors and Principal Stockholders, Exchange Act Release No. 27,148, [1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 84,439, at 80,384 (Aug. 18, 1989) (reproposing release).

210 *Id.*

211 Rule 16a-2(a) continues to apply § 16 to transactions by officers and directors that take place within six months before the issuer's registration of a class of equity securities under § 12 of the Exchange Act. 17 C.F.R. § 240.16a-2(a) (1991). *See infra* notes 233-41 and accompanying text.

212 17 C.F.R. § 240.16a-2(a) (1991).

213 15 U.S.C. § 78p(b).

214 *See, e.g.,* Arrow Distrib. Corp. v. Baumgartner, 783 F.2d 1274, 1279 (5th Cir. 1986); Feder v. Martin Marietta Corp., 406 F.2d 260, 266 (2d. Cir. 1969), *cert. denied*, 396 U.S. 1036 (1970); Adler v. Klawans, 267 F.2d 840, 846-47 (2d Cir. 1959); Blau v. Allen, 163 F. Supp. 702, 704 (S.D.N.Y. 1958).



time of purchase or sale to be a statutory insider."<sup>215</sup> In another relatively recent decision, the Fifth Circuit adhered to this approach.<sup>216</sup> And, in perhaps the seminal case, *Adler v. Klawans*,<sup>217</sup> the Second Circuit held that, where a director purchases before assuming office and sells within the "short-swing" period during his tenure, section 16(b) liability will attach.<sup>218</sup> According to *Adler*, the Congress intended for section 16(b) to discourage widespread abuse of fiduciary relations and specifically to deter officers, directors, and ten percent beneficial owners from making improper use of information gained in a representative capacity.<sup>219</sup> Moreover, the Second Circuit in *Adler* asserted that the language of section 16 was so clear that it was unnecessary to examine legislative history to determine whether Congress intended pre-insider transactions by officers or directors to be subject to section 16(b).<sup>220</sup> Section 16(b) states that: "This subsection shall not be construed to cover any transaction where such beneficial owner was not such both at the time of purchase and sale."<sup>221</sup> Hence, the court felt that the presence of this emphatic statement, along with the absence of such a requirement with respect to officers or directors, demonstrated a clear legislative intent that no such limitation be applied to the latter.<sup>222</sup> In sum, the court believed that it was Congress's purpose to "reach a 'purchase and sale' or 'sale and purchase' within a six month period by someone within one of the proscribed categories, [such as] one who was a director [or] officer . . . at some time."<sup>223</sup> As reflected in *Adler*, applying section 16(b) to pre-insider trades by officers and directors

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215 *Riseman v. Orion Research, Inc.*, 749 F.2d 915, 917 (1st Cir. 1984).

216 *Arrow Distrib. Corp.*, 783 F.2d at 1279 ("[A]n insider's short-swing transaction is subject to Section 16(b) if the insider has held his corporate position at either the time of his purchase or the time of his sale.").

217 267 F.2d 840 (2d Cir. 1959).

218 *Id.*; see also *Riseman*, 749 F.2d at 917 ("An officer or director need only hold the position at the time of purchase or sale to be a statutory insider.").

219 *Adler*, 267 F.2d at 844.

220 *Id.*

221 15 U.S.C. § 78p (b); see § 16(b), *supra* note 17.

222 *Adler*, 267 F.2d at 845; see JACOBS, *supra* note 39, § 3.03.

223 *Adler*, 267 F.2d at 845 (emphasis in original); see also *Arrow Distrib. Corp. v. Baumgartner*, 783 F.2d 1274, 1279 (5th Cir. 1986) (Examining congressional intent, the Fifth Circuit held that "an insider's short-swing transaction is subject to Section 16(b) if the insider has held his corporate position at either the time of his purchase or the time of his sale.") (citing *Feder v. Martin Marietta Corp.*, 406 F.2d 260, 262 (2d Cir. 1969), *cert. denied*, 396 U.S. 1036 (1970)).

advances congressional intent and is consonant with the purposes and policies underlying section 16(b).<sup>224</sup>

In holding that a director's or officer's purchases and sales before assuming office are subject to section 16(b), the courts have rejected an analysis looking to the intent of the acting party. In *Blau v. Allen*,<sup>225</sup> for example, the court stated that a purchaser "need not have access to inside information in entering into his initial transaction."<sup>226</sup> The court held that the defendant's speculation, having become an insider by virtue of becoming a director, was a "vice within the purview of Section 16(b)."<sup>227</sup> Several courts have followed *Allen's* rationale.<sup>228</sup> Refusing to examine a party's subjective intent comports with Congress's purpose in enacting section 16 which holds insiders strictly liable for their short-selling profits, without regard to the motive or intent of the violator.<sup>229</sup>

#### D. Policy Considerations

Although it seems from the language of section 16(b) that ten percent beneficial owners are to be treated differently than officers or directors,<sup>230</sup> there may not be a sufficient justification for this apparent distinction. An argument can be made that, with respect to all such persons covered under the statute, section 16(b) liability should not be imposed when the initial transaction is entered into prior to acquiring insider status.

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224 *Adler*, 267 F.2d at 844.

225 163 F. Supp. 702 (S.D.N.Y. 1958).

226 *Id.* at 704.

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

228 *See, e.g., Arrow Distrib. Corp. v. Baumgartner*, 783 F.2d 1274 (5th Cir. 1986).

229 *Id.* at 1281 ("[N]either actual use of insider information nor intention to exploit such information is required to establish § 16(b) liability."); *Allen*, 163 F. Supp. at 705 ("Motive is immaterial in determining liability under section 16(b)." (citing *Stella v. Graham-Paige Motorts Corp.*, 132 F. Supp. 100 (S.D.N.Y. 1955))); *Sterman v. Ferro Corp.*, 785 F.2d 162, 166 (6th Cir. 1986) ("Section 16(b) imposes a strict liability upon transactions coming within its parameters and this court has long recognized that consideration of issues such as motive, intent and the use or abuse of inside information is irrelevant in analyzing actions under its mandates.").

230 Recall the exemptive proviso to § 16(b) which states that "this subsection shall not be construed to cover any transaction where such beneficial owner was not such both at the time of purchase and sale, or the sale and purchase, of the security involved . . ." 15 U.S.C. § 78p(c) (1988); *see Foremost-McKesson, Inc. v. Provident Sec. Co.*, 423 U.S. 232 (1976); *Reliance Elec. Co. v. Emerson Elec. Co.*, 404 U.S. 418 (1972). These cases are discussed in MARC I. STEINBERG, *SECURITIES REGULATION: LIABILITIES AND REMEDIES* § 4.05 (1992).

The statute seeks to prevent the unfair use of information by one who has a sufficiently close relationship to the issuing corporation. Just why an officer or director who has made a purchase previous to having acquired his position is any more likely to subsequently trade on inside information than an outsider who attains insider status by virtue of having bought ten percent of the corporation's outstanding stock, is never clearly articulated, neither in the statute on its face, nor in the legislative history accompanying the statute, nor in judicial opinions examining this issue. It can be further argued that there is a philosophical inconsistency in taking an overly rigid approach here, where elsewhere the courts have been receptive to adopting a pragmatic approach when they are analyzing whether certain unorthodox transactions can be deemed purchases and sales within the meaning of the statute.<sup>231</sup> Nonetheless, a key distinction exists: a director or an executive officer, by the nature of her position alone, normally has access to inside information while the same does not necessarily hold true for a ten percent beneficial owner. Hence, the inherent access to inside information that directors and executive officers enjoy, in conjunction with the statute's policy of deterring fiduciaries from making improper use of information gained in their representative capacity, requires that the statute be interpreted as subjecting pre-insider transactions by such insiders to section 16(b).

It is difficult to understand the SEC's change in policy, resulting in the exemption of pre-insider transactions by officers and directors from section 16, when respected case law clearly establishes that section 16(b) is applicable to pre-insider trades of officers and directors. Explaining its decision, the SEC cited the concerns of commentators that "disclosure of officer or director transactions before attaining insider status is unnecessarily harsh in that it subjects those persons to liability, even though they may not have known at the time of the transactions that they would be-

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231 See S. REP. NO. 792, 73d Cong., 2d Sess. 9 (1934). For cases applying the pragmatic approach, see, e.g., *Kern County Land Co. v. Occidental Petroleum Corp.*, 411 U.S. 582 (1973); *Heublein, Inc. v. General Cinema Corp.*, 722 F.2d 29 (2d Cir. 1983); *Texas Int'l Airlines v. National Airlines, Inc.*, 714 F.2d 533 (5th Cir. 1983); *Portnoy v. Memorex Corp.*, 667 F.2d 1281 (9th Cir. 1982). For scholarly commentary on this issue, see Thomas L. Hazen, *The New Pragmatism Under Section 16(b) of the Securities Exchange Act*, 54 N.C. L. REV. 1 (1975); STEINBERG, *supra* note 230, § 4.06; Timothy Tomlinson, *Section 16(b): A Single Analysis of Purchases and Sales - Merging the Objective and Pragmatic Analyses*, 1981 DUKE L.J. 941.

come officers or directors in the future.<sup>232</sup> The simple answer to this concern is that a person assuming officer or director status will not incur section 16 liability so long as the insider complies with the provisions of that statute. In such event, the insider need only wait the designated time period before engaging in the offsetting transaction(s). Hence, in accepting a fiduciary position such as that of a principal executive in a publicly held company, one should expect to incur certain obligations. One such obligation is to refrain from engaging in short-swing trading. The fact that a prospective officer or director did not anticipate being made subject to the limitations of section 16 should not change the result.

### 1. Rule 16a-2(a)'s Inconsistency with Congressional Policy Underlying Section 16(b)

A persuasive argument can be set forth that the SEC's decision to exclude pre-insider trades by officers and directors from section 16 runs afoul of the policies underlying section 16(b). Section 16(b)'s focus is on deterring officers, directors, and ten percent beneficial owners from making improper use of information gained in a representative capacity.<sup>233</sup> It is obvious that a person need not be a statutory insider at the time of both the purchase and sale (or sale and purchase) in order to engage in this sort of speculative conduct. If the insider receives and uses material nonpublic information in only the trade made after attaining insider status, such insider still has engaged in activity that is contrary to the rationale underlying section 16(b).<sup>234</sup> By enabling officers and directors to use inside information to offset pre-insider trades, the SEC minimizes section 16(b)'s remedial focus.

In addition to the assertion that the Commission's action contravenes the congressional purpose underlying section 16(b), rule 16a-2(a) is not only internally inconsistent but also inconsistent with other positions adopted by the SEC. The internal inconsistency exists because at the same time rule 16a-2(a) excludes the applicability of section 16 to pre-insider transactions, it continues to apply section 16 to transactions by officers and directors that take place within six months before the subject issuer's registration

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232 Ownership Reports and Trading by Officers, Directors and Principal Security Holders, *supra* note 209, at 80,384.

233 *See, e.g.,* Adler v. Klawans, 267 F.2d 840, 844 (2d Cir. 1959).

234 *See* JACOBS, *supra* note 39, § 3.03.

of a class of equity securities under section 12 of the Exchange Act.<sup>235</sup> The Commission justifies this position on the rationale that "[i]nsiders of private companies should be well aware of plans to register under section 12 sufficiently in advance to take potential section 16 responsibilities into account in buying and selling issuer securities."<sup>236</sup> In making this statement, the SEC's focus evidently is on the insider's awareness of his potential section 16(b) liability. If so, the Commission's perception is misplaced. As the prevailing case law makes abundantly clear, the Commission's focus should be on the underlying purpose of section 16(b) which is to deter and prevent insider trading. The culpability of the alleged violator is not a relevant factor in ascertaining one's obligations and liabilities under section 16.<sup>237</sup>

On a practical level, the SEC's distinction between officer and director transactions which occur six months prior to an issuer going public,<sup>238</sup> and trades occurring just before the officer or director otherwise takes office, is not persuasive. The concern in each of these transactions is that the insider will use nonpublic information to which the insider is now privy to offset a trade made before the individual had access to such information. Eliminating the applicability of section 16 to one such transaction while applying it to the other is inconsistent with the statute's purpose. In *Arrow Distribution Corp. v. Baumgartner*,<sup>239</sup> for example, the Fifth Circuit recognized the similarity of the two types of transactions and the necessity of applying section 16(b) to both.<sup>240</sup> *Baumgartner* reaches the proper result because it subjects these two analogous transactions to section 16(b). This decision furthers the

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235 17 C.F.R. § 240.16a-2(a) (1991).

236 Ownership Reports and Trading by Officers, Directors and Principal Stockholders, *supra* note 209, at 80,384.

237 See, e.g., *Adler v. Klawans*, 267 F.2d 840 (2d Cir. 1959); see cases cited *supra* note 229.

238 "Going public" is a process whereby an issuer embarks upon a plan of financing in which securities are sold to the public. MARC I. STEINBERG, UNDERSTANDING SECURITIES LAW 249 (1989). "The issuer thereby becomes subject to the reporting requirements of the Exchange Act." *Id.* The first public offering of securities that an issuer makes is referred to as an "initial public offering." By doing so the issuer "goes public" and becomes subject to the Exchange Act's reporting obligations. *Id.* at 249-51.

239 783 F.2d 1274 (5th Cir. 1986).

240 *Id.* at 1279. While asserting that "short-swing transactions effected by a director or officer are subject to § 16(b) even though the issuer's securities were registered under § 12(g) of the Act only at the time of purchase or sale," the court also concluded that "an insider's short-swing transaction is subject to § 16(b) if the insider has held his corporate position at either the time of his purchase or the time of his sale." *Id.*

underlying purpose of section 16 which is to prevent insiders from profiting from the use of nonpublic information.

## 2. Rule 16a-2(a)'s Inconsistency with Other Positions Adopted by the SEC

In addition to being internally inconsistent, rule 16a-2(a) is inconsistent with other positions adopted by the SEC. For example, rule 16a-2(b) subjects offsetting transactions following the cessation of director or officer status to section 16 if executed within six months of a transaction that occurred while that person was a director or officer.<sup>241</sup> This rule acknowledges that it is unnecessary for an individual to have insider status when she engages in both trades in order to be a party whose trades are the type section 16(b) seeks to oversee. While the SEC acknowledges in rule 16a-2(a) that one may use inside information ascertained when one was an officer or director to execute a trade after insider status is terminated, it apparently does not want to recognize that insiders may use inside information in effecting transactions once insider status is attained to offset transactions executed before attaining insider status.<sup>242</sup>

### E. Summation

Congress's intent, as interpreted by the courts and which is clear from the plain language of the statute, is that section 16(b) applies to a person's transactions which occur prior to that indi-

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<sup>241</sup> 17 C.F.R. § 240.16a-2(b) (1991); *see, e.g., Lewis v. Mellon Bank*, 513 F.2d 921, 924 (3d Cir. 1975); *Feder v. Martin Marietta Corp.*, 406 F.2d 260, 262-63 (2d Cir. 1969), *cert. denied*, 396 U.S. 1036 (1969) (transactions by officers after they cease to hold office are subject to § 16 if executed within six months of a transaction that occurred while that officer was an insider).

On the other hand, where both transactions occur within a six month period after an officer or director has terminated such status, no § 16(b) liability will be found. *See Lewis v. Varnes*, 505 F.2d 785 (2d Cir. 1974); *Levy v. Seaton*, 358 F. Supp. 1 (S.D.N.Y. 1973).

<sup>242</sup> In the reproposing release on the § 16 rule amendments, the SEC seemed to recognize the significance of the rule change it was about to make. The Commission's concern over the reproposed rule is reflected in the comments that were solicited. The SEC asked for comment, for example, on whether it was preferable to maintain the then existing § 16 regimen on this subject, or alternatively, to subject pre-insider transactions to § 16 only when the person knows or has reason to know that he or she will become an officer or director. Furthermore, the SEC asked for comment on whether pre-insider trades should be exempt from both § 16(a) and § 16(b), or only from the short-swing profit recovery provisions of § 16(b). *Ownership Reports and Trading by Officers, Directors and Principal Stockholders*, *supra* note 209, at 80,384.

vidual assuming a position as an officer or director. This policy is in accordance with the purpose of section 16. The SEC rule exempting officer and director pre-insider transactions from section 16 directly contradicts the congressional purpose of deterring persons having insider status from using nonpublic information when engaging in securities transactions. Furthermore, the rule creating the exemption is internally inconsistent and inconsistent with other positions taken by the SEC. In sum, it appears that the Commission has made a policy decision benefiting prospective insiders while ignoring the risk that such persons will use their access to nonpublic information in order to offset trades made shortly before they attained their insider status. Therefore, it appears that the SEC has exceeded its rulemaking authority by instituting this policy.

## V. CONCLUSION

This Article has focused on recent judicial and SEC actions that limit section 16's scope. In particular, the Commission's rulemaking endeavors may strike one as surprising. Given that section 16 is an explicit congressional directive to combat insider trading, one logically would conclude that the Commission would interpret the statute so as to effectuate its remedial objective. This is particularly the case in view of the SEC's declared war on insider trading. Yet, while seeking to expand the parameters of such antifraud provisions as section 10(b) and rule 14e-3,<sup>243</sup> the SEC has relaxed the mandates of section 16.

This development, albeit puzzling, is not an isolated one. Recently, in the midst of an election year, the Commission passed amendments to its limited offering rules,<sup>244</sup> the effect of which is to expose the exceptions previously in effect.<sup>245</sup> The ostensible

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243 17 C.F.R. § 240.14e-3 (1991) (broad rule prohibiting trading on or tipping of inside information in the tender offer context). The rule was upheld by the Second Circuit in *United States v. Chestman*, 947 F.2d 551 (2d Cir. 1991) (en banc), cert. denied, 112 S. Ct. 1759 (1992). See *O'Conner & Assoc. v. Dean Witter Reynolds, Inc.*, 529 F. Supp. 1179 (S.D.N.Y. 1981); Samuel H. Gruenbaum, *The New Disclose or Abstain from Trading Rule: Has the SEC Gone Too Far?*, 4 CORP. L. REV. 350 (1981); Theodore A. Levine et al., *Multiservice Securities Firms: Coping with Conflicts in a Tender Offer Context*, 23 WAKE FOREST L. REV. 41 (1988); Note, *Trading on Material Nonpublic Information Under Rule 14e-3*, 49 GEO. WASH. L. REV. 539 (1981).

244 Small Business Initiatives, Securities Act Release No. 6949 (July 30, 1992); see also Separate Statement of Commissioner Fleischman, Securities Act Release Nos. 6925, [1991-1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 84,932 (March 18, 1992).

245 Among other things, the amendments drastically modified the Regulation A and

purpose underlying these amendments is to facilitate capital formation by small business.<sup>246</sup> Although this is certainly a laudable objective, the SEC is not a Chamber of Commerce. Its role is to protect the investing public and the integrity of the securities markets.<sup>247</sup>

There may be a disconcerting trend taking place: The SEC, while energetically enforcing the antifraud provisions, may be bowing to pressure from business interests to relax some of the "technical" aspects of securities regulation. Hopefully, this in fact is not the situation. In its wisdom, Congress declined to enact securities statutes solely concerned with fraud. Rather, the securities laws address a wider range of conduct and establish a broad array of remedial and punitive measures to respond to proscribed conduct.<sup>248</sup> It is the SEC's responsibility to vigorously implement these congressional mandates. Hopefully, rather than shirking from this obligation, the Commission will act in the manner that Congress directed.

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Rule 504 exemptions from registration. See Kenneth J. Bialkin, *Defending the SEC from Deregulators*, NAT'L L.J., Apr. 20, 1992, at 20.

246 See Small Business Initiatives, *supra* note 244, at 2; Separate Statement of Commissioner Fleischman, *supra* note 244, at 3.

247 See, e.g., *United States v. Naftalin*, 441 U.S. 768 (1979). For further discussion, see Marc I. Steinberg, *Section 17(a) of the Securities Act After Naftalin and Redington*, 68 GEO. L.J. 163 (1979).

248 These measures are addressed in two treatises by the author: See STEINBERG & FERRARA, *supra* note 2; STEINBERG, *supra* note 230; see also ALAN R. BROMBERG & LEWIS D. LOWENFELS, *SECURITIES FRAUD AND COMMODITIES FRAUD* (1991).



