

# COMMENTS

## MINIMIZING SECTION 16(b) LIABILITY FOR BENEFICIAL OWNERS—TWO-STEP TRANSACTIONS

### *Reliance Electric Co. v. Emerson Electric Co.,* 404 U.S. 418 (1972)

Emerson Electric Company attempted to gain control of Dodge Manufacturing Company by acquiring 13.2 percent of Dodge common stock on June 16, 1967, at \$63 per share. On August 22, Emerson's effort to acquire control of Dodge was thwarted by the approval by Dodge shareholders of a plan to merge Dodge with Reliance Electric Company. On August 28, Emerson sold 37,000 shares of Dodge stock at \$68 per share, thereby reducing its holdings to 9.96 percent of the outstanding shares. Emerson sold its remaining shares to Dodge at \$69 per share on September 11. Emerson's counsel recommended this two-step disposition as a means of minimizing the company's liability under section 16(b) of the Securities Exchange Act of 1934.<sup>1</sup> Predicating its demand on section 16(b), the merged corporation demanded that Emerson pay to it the profit from both sales. In a declaratory judgment action brought by Emerson, the district court held Emerson liable for the profit on both sales.<sup>2</sup> The United States Court of Appeals for

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1. *Reliance Elec. Co. v. Emerson Elec. Co.*, 404 U.S. 418, 420 (1972). See 15 U.S.C. § 78p(b) (1970):

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 less than six months . . . shall inure to and be receivable by the issuer, irrespective of any intentions 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. . . . 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, or any transaction or transactions which the Commission by rules and regulations may exempt as not comprehended within the purpose of this subsection.

2. *Reliance Elec. Co. v. Emerson Elec. Co.*, 306 F. Supp. 588 (E.D. Mo. 1969).

the Eighth Circuit reversed as to the liability for the profit on the second sale.<sup>3</sup> The United States Supreme Court affirmed and *held*: When the owner of more than ten percent of the outstanding registered shares of a corporation disposes of the stock in two sales, the first of which reduces his holdings below ten percent, he incurs no liability under section 16(b) for the profit realized on the second sale.<sup>4</sup>

In order to protect the investing public, the Securities and Exchange Act of 1934 regulates securities transactions and prohibits the use of fraud and manipulation in securities trading.<sup>5</sup> Section 16(b) was designed to promote an "honest market"<sup>6</sup> and to prevent the misuse of privileged information<sup>7</sup> by denying insiders profit from "short-swing" transactions.<sup>8</sup> The statute imposes strict liability on certain transactions without regard to proof of actual possession or use of inside information.<sup>9</sup> An insider, that is, an officer, director, or the beneficial owner

3. *Reliance Elec. Co. v. Emerson Elec. Co.*, 434 F.2d 918 (8th Cir. 1970). Emerson never contested liability for the first sale.

4. Because only the merged corporation sought certiorari, only the liability for the profit on the September sale was at issue before the Supreme Court.

5. The introductory section of the 1934 Act explains the legislative intent. 15 U.S.C. § 78p(b) (1970). Loss suggests that the 1934 Act has four purposes: "to afford a measure of disclosure to people who buy and sell securities; to prevent and afford remedies for fraud in securities trading and the manipulation of the market; to regulate the securities market; and to control the amount of the nation's credit which goes into these markets." 1 L. LOSS, *SECURITIES REGULATIONS* 130-31 (2d ed. 1966). See *Thill Securities Corp. v. New York Stock Exchange*, 433 F.2d 264 (7th Cir. 1970); *Beck v. SEC*, 430 F.2d 673, 674 (6th Cir. 1970); *Moscarella v. Stamm*, 288 F. Supp. 453 (E.D. N.Y. 1968).

6. See 15 U.S.C. § 78b (1970). See also *Smolowe v. Delendo Corp.*, 136 F.2d 231 (2d Cir.), *cert. denied*, 320 U.S. 751 (1943).

7. At the congressional hearings prior to the enactment of the 1934 Act, corporate insiders described common practices of abuse of insider information. S. REP. No. 1455, 73d Cong., 2d Sess. 32-33, 47, 68 (1934). See *Emerson Elec. Co. v. Reliance Elec. Co.*, 434 F.2d 918, 922 (8th Cir. 1970); *Booth v. Varian Associates*, 334 F.2d 1 (1st Cir. 1964); *Shaw v. Dreyfus*, 172 F.2d 140, 142 (2d Cir. 1949).

8. *Reliance Elec. Co. v. Emerson Elec. Co.*, 404 U.S. 418, 420 (1972); *Heli-Coil Corp. v. Webster*, 352 F.2d 156, 170 (3d Cir. 1965); *Ferraiolo v. Newman*, 259 F.2d 342, 346 (6th Cir. 1958).

9. See *Western Auto Supply Co. v. Gambel-Skogmolo, Inc.*, 348 F.2d 736 (8th Cir. 1965); *Reliance Elec. Co. v. Emerson Elec. Co.*, 306 F. Supp. 588 (E.D. Mo. 1969). Thus one who trades within six months need not intend to utilize inside information nor must he necessarily possess any to be liable. See 72 HARV. L. REV. 1392 (1959) for criticism of this § 16(b) strict liability. For a general explanation, see Note, *Section 16(b): Re-Evaluation is Needed*, 25 U. MIAMI L. REV. 144 (1970); 84 HARV. L. REV. 1012 (1971); 41 TEX. L. REV. 448 (1963); 111 U. PA. L. REV. 688, 689 (1963); 18 WEST. RES. L. REV. 986 (1967). See also *B.T. Babbitt, Inc. v. Lachner*, 332 F.2d 255 (2d Cir. 1964); *Gratz v. Claughton*, 187 F.2d 46 (2d Cir. 1951); *Smolowe v.*

of more than ten percent of a corporation's stock,<sup>10</sup> who purchases and sells stock or vice-versa within a six month period must return any profit to the corporation.<sup>11</sup> The insider, however, who has held stock for more than six months may sell or buy on the basis of inside information without incurring liability under section 16(b).<sup>12</sup> The section primarily aims at the insider who acquires information, buys or sells before that information is publicly available, and then restores his position after the market has reacted to the news.<sup>13</sup>

Section 16(b) treats ten percent owners differently from other insiders when the shareholders are not ten percent owners at both ends of the transaction, explicitly providing that, "[T]his subsection shall not be construed to cover any transactions where such beneficial owner was not such both at the time of the purchase and sale, or the sale and purchase."<sup>14</sup> Though courts have interpreted section 16(b) to imply that directors and officers are liable even if they do not hold their office at both ends of the short-swing transaction,<sup>15</sup> the *Reliance* court, considering

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*Delendo Corp.*, 136 F.2d 231, 236 (2d Cir.), *cert. denied*, 320 U.S. 751 (1943); *Abrams v. Occidental Petroleum Corp.*, 323 F. Supp. 570 (S.D.N.Y. 1970). For this reason, it has been said the law operates as a "crude rule of thumb." This often repeated phrase was made by the chief spokesman for the draftsmen of the 1934 Act. *See Hearings on Stock Exchange Practices Before the Senate Comm. on Banking and Currency*, 73d Cong., 2d Sess. 6557 (1934). *See also* 2 L. Loss, *supra* note 5, at 1040-44. The element of strict liability enables one to recover easily in many instances, since cases reading the statute literally require no proof of possession or use of inside information. For cases dealing with factual situations which did not lend themselves to abuse of such information, *see Blau v. Lamb*, 363 F.2d 507 (2d Cir. 1966); *Ferraiolo v. Newman*, 259 F.2d 342 (6th Cir. 1958); *Alloys Unlimited, Inc. v. Gilbert*, 319 F. Supp. 617 (S.D. N.Y. 1970).

10. The ten percent requirement does not apply to officers and directors. These corporate officials have enough opportunity to obtain inside information without owning a particular percentage of corporate stock; they are insiders by virtue of their office. To be subject to § 16(b) liability, a beneficial owner's holdings can be any class of equity security registered on the national exchange. *See* 15 U.S.C. § 78p(a) (1970).

11. The time period of six months was chosen because Congress believed that the temptation for an insider is greatest within a short period of time. *See Blau v. Max Factor & Co.*, 342 F.2d 304, 308 (9th Cir. 1965).

12. He might, however, be liable under other sections of the Securities Exchange Act of 1934, such as § 10(b). This liability would not be premised upon the short-swing nature of the transaction.

13. The classic case is the director who has inside knowledge that the corporation is about to suspend dividend payments. He sells a large block of shares, announces the omitted dividend, and then restores his holdings at the depressed market value. *See* 73 HARV. L. REV. 1630 (1960).

14. 15 U.S.C. § 78p(b) (1970).

15. For cases holding officers and directors liable for short-swing transactions al-

the explicit language of 16(b), held that ten percent beneficial owners are not liable unless they hold ten percent at both ends of the transaction.<sup>16</sup>

In *Reliance*, the Supreme Court applied the beneficial owner exclusion of section 16(b) to a split sale without questioning the reasons behind separate treatment of officers and directors on the one hand and beneficial owners on the other. In *Adler v. Klawans*,<sup>17</sup> however, the Second Circuit explained that Congress intended to treat beneficial owners differently from officers and directors because "officers and directors have more ready access to the intimate business secrets of corporations and factors which can affect the real and ultimately the market value of stock than does even so large a stockholder as a '10% beneficial owner.'"<sup>18</sup> The *Adler* court stated that this reasoning is supported by experience and furnishes an adequate basis for the preferential treatment of ten percent owners.<sup>19</sup>

The *Reliance* decision results in equal treatment of shareholders owning less than ten percent of the shares at one end of the transaction, regardless of whether there had been a series of transactions reducing the holdings to less than ten percent. It may be argued that failing to take into account the sales reducing holdings to less than ten percent defeats the congressional purpose behind the Act,<sup>20</sup> but the Court in

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though not in office at both the time of purchase and sale, *see Feder v. Martin Marietta Corp.*, 406 F.2d 260 (2d Cir. 1969), *cert. denied*, 396 U.S. 808 (1970); *Adler v. Klawans*, 267 F.2d 840 (2d Cir. 1959); *Bershad v. McDonough*, 300 F. Supp. 1051 (N.D. Ill. 1969); *Marquette Cement Mfg. Co. v. Andreas*, 239 F. Supp. 962 (S.D.N.Y. 1965); *Blau v. Allen*, 163 F. Supp. 702 (S.D.N.Y. 1958). *See also* 44 B.U.L. REV. 598 (1969); 1969 DUKE L.J. 812 (1969); 21 U. PITT. L. REV. 551 (1960); 22 VAND. L. REV. 1003 (1969).

The same is true with stocks unlisted on the exchange at one end of the transaction. *See Perfect Photo, Inc. v. Grabb*, 205 F. Supp. 569 (E.D. Pa. 1962); *See also* 49 VA. L. REV. 347 (1963). Apparently, this issue has never been decided at the circuit court level.

16. *Reliance Elec. Co. v. Emerson Elec. Co.*, 404 U.S. 418, 424 (1972).

17. 267 F.2d 840 (2d Cir. 1959).

18. *Id.* at 845.

19. It is interesting to note that the court gave no authority for its conclusions, but did assert, without clarification, that there are important exceptions to the rule that officers and directors have more access to factors affecting market value than ten percent beneficial owners. *See generally Stella v. Graham-Paige Motors Corp.*, 232 F.2d 299 (10th Cir. 1956); *Smolowe v. Delendo Corp.*, 136 F.2d 231 (2d Cir. 1943); 2 L. Loss, *supra* note 5, at 1060, 1061. *Stella v. Graham-Paige Motors Corp.* limited the applicability of the separate treatment of beneficial owners by holding that one becomes a beneficial owner at the very moment one's holdings are increased to ten percent.

20. There have been two lines of decisions interpreting § 16(b). *See Bateman*,

*Reliance* specifically ruled that Congress intended the statute to set up a literal standard and that to impose 16(b) liability on this transaction would "flatly contradict the words of the statute."<sup>21</sup> It is unlikely that preferential treatment of ten percent beneficial owners will defeat the congressional intent, since most ten percent owners come under insider liability as officers or directors of the company even if a multi-transaction share reduction is undertaken. In addition, perhaps Congress believed that being a beneficial owner in itself entails less freedom of access to inside information than that allowed to directors and officers, and did not wish to discourage investment in the midst of the Great Depression by unnecessarily exposing stockholders to liability.

Justice Douglas, dissenting in *Reliance*, believes that the congressional purpose requiring that the beneficial owner be such an owner at both ends of the transaction was intended to exclude from liability only those who became ten percent holders involuntarily.<sup>22</sup> If, however,

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

In the early cases which interpreted section 16(b) for the first time, the courts adopted an extremely literal and often harsh interpretation of its provisions, which has since come to be known as the objective method. For many years, this was the generally accepted method of interpretation. In later cases which presented even more difficult issues, however, the courts gradually began to move to a more pragmatic or subjective approach to the interpretation of 16(b), which has placed relatively more emphasis on the policy of the statute and less on its literal terms.

With *Reliance*, the Supreme Court has apparently adopted an objective approach.

For cases adopting this objective, or literal, approach to § 16(b) liability, see *Heli-Coil v. Webster*, 352 F.2d 156 (3d Cir. 1965); *Gratz v. Claughton*, 187 F.2d 246 (2d Cir. 1951); *Park and Tilford v. Schulte*, 160 F.2d 984 (2d Cir. 1947); *Smolowe v. Delendo Corp.*, 136 F.2d 231 (2d Cir.), *cert. denied*, 320 U.S. 751 (1943). For discussion of this method of interpretation, see *Ferraiolo v. Newman*, 259 F.2d 342 (6th Cir. 1958); *Heli-Coil v. Webster*, *supra*; *Bateman*, *supra*; *Lowenfels, Section 16(b): A New Trend in Regulating Insider Trading*, 54 CORNELL L. REV. 45 (1968); 117 U. PA. L. REV. 1034, 1036 (1969).

For cases adopting the subjective, or expansive, approach to § 16(b) liability, see *Bershad v. McDonough*, 428 F.2d 693 (7th Cir. 1970); *Feder v. Martin Marietta Corp.*, 406 F.2d 260 (2d Cir. 1969), *cert. denied*, 396 U.S. 808 (1970); *Petteys v. Butler*, 367 F.2d 528 (8th Cir. 1966); *Blau v. Lamb*, 363 F.2d 507 (2d Cir. 1966); *Blau v. Max Factor & Co.*, 342 F.2d 304 (9th Cir. 1965).

Although the Supreme Court interprets the statute literally in finding Emerson not liable, the Court probably would have reached the same result if the subjective approach had been employed, for there was little chance of abuse of inside information since Emerson's sole concern was liquidation of its stock after the abortive merger attempt.

21. 404 U.S. at 427.

22. The dissent, arguing that the congressional purpose demands that corporate

Congress had intended to limit the exception in this manner, it could have done so in a much clearer provision. Moreover, given the overall purpose of the statute, to prohibit unfair use of inside information only under specified circumstances, it seems unlikely that Congress would have limited the exception to this instance.<sup>23</sup>

Factually, the circumstances in this case were somewhat unique in that Emerson had no inside information and only decided to sell the shares so quickly when its attempted takeover of Dodge was thwarted. The Court failed to indicate what influence, if any, these factors had on its decision. Since other traders will be encouraged to adopt techniques similar to those of Emerson, the Court should have provided reasons for the statutory preferential treatment of beneficial shareholders in general and explained its treatment of the split sale situation in light of these reasons.

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insiders should not be able to avoid liability imposed by § 16(b) so easily, suggested that "sale" should be construed to include any plan formulated within six months of any purchase made during the period in which the purchaser is a beneficial owner. This would create a presumption that any purchase and sale within six months is part of a single plan of disposition and should be subject to § 16(b) liability. This interpretation would mean that Emerson's second sale would be considered as part of the first; thus Emerson would be liable for all short-swing profits under § 16(b). *Reliance Elec. Co. v. Emerson Elec. Co.*, 404 U.S. 418, 427 (1972).

23. See notes 6 and 8 *supra* for the general purpose of § 16(b). See also Note, *Section 16(b): Re-Evaluation Is Needed*, 25 U. MIAMI L. REV. 144 (1970).