

III. SECTION 16(b): INSIDER TRADING

Prior to the passage of the Securities Exchange Act of 1934 (1934 Act), the common law provided few remedies for the abuses arising from speculative trading in securities by officers, directors, and substantial shareholders.²⁸³ Courts in various jurisdictions relied on one of three theories to provide relief from insider speculative practices. First, the majority of courts followed the theory that officers and directors owed no fiduciary duty to stockholders and that an insider would incur liability only if he actively perpetrated a fraud.²⁸⁴ Secondly, a few courts followed the theory that officers and directors did owe a fiduciary duty to stockholders, and thus these insiders had a duty to disclose all material facts affecting the value of shares.²⁸⁵ Finally, some courts followed the "special circumstances" theory, first announced in *Strong v. Repide*,²⁸⁶ in which officers and directors were held not to owe a fiduciary duty to stockholders unless special facts made it inequitable for the insider to take advantage of the stockholders.²⁸⁷ In addition, certain substantial shareholders were held to owe a fiduciary duty to minority shareholders where the substantial shareholder held a position of influence over cor-

283. For an excellent discussion of the common law approach to insider trading, see Yourd, *Trading in Securities by Directors, Officers and Stockholders: Section 16 of the Securities Exchange Act*, 38 MICH. L. REV. 133, 139-43 (1939). See also *Heli-Coil Corp. v. Webster*, 352 F.2d 156, 160 (3d Cir. 1965); *Smolowe v. Delendo Corp.*, 136 F.2d 231, 235-36 (2d Cir.), cert. denied, 320 U.S. 751 (1943); *Cook & Feldman, Insider Trading Under the Securities Exchange Act*, 66 HARV. L. REV. 385, 408-10 (1953); Note, *Section 16(b): Re-evaluation is Needed*, 25 U. MIAMI L. REV. 144, 145-46 (1970).

284. See, e.g., *Board of Comm'rs v. Reynolds*, 44 Ind. 509 (1873); *Carpenter v. Danforth*, 52 Barb. 581 (N.Y. Sup. Ct. 1868); *Fisher v. Budlong*, 10 R.I. 525 (1873); *Deaderick v. Wilson*, 67 Tenn. 87 (1874); *Voellmack v. Harding*, 166 Wash. 93, 6 P.2d 373 (1931). See generally Annot., 84 A.L.R. 615 (1933).

285. See, e.g., *Steinfeld v. Nielsen*, 15 Ariz. 424, 139 P. 879 (1914); *Oliver v. Oliver*, 118 Ga. 362, 45 S.E. 232 (1903); cf. *Perry v. Pearson*, 135 Ill. 218, 25 N.E. 636 (1890). See generally A. BERLE, *STUDIES IN THE LAW OF CORPORATION FINANCE* 176-88 (1928).

286. 213 U.S. 419 (1909).

287. In more recent cases, a few state courts have held that inside information is a corporate asset and that misuse of this information by a director is a breach of the director's fiduciary duty to the corporation. Under this theory, the remedy granted to the corporation is in the form of a constructive trust. See, e.g., *Brophy v. Cities Serv. Co.*, 31 Del. Ch. 241, 70 A.2d 5 (Ch. 1949); *Diamond v. Oreamuno*, 29 App. Div. 2d 285, 287 N.Y.S.2d 300 (1968).

porate management.²⁸⁸

Both because the majority of courts held that officers, directors, and substantial shareholders owed no fiduciary duty to shareholders in general, and because the elements of insider liability were often too difficult for injured shareholders to establish, the common law remedies proved to be an inadequate deterrent to abusive insider trading.²⁸⁹ Frequent reports of the misuse of inside information dramatically demonstrated to Congress the remedial impotence of the common law.²⁹⁰ This impotence was viewed by Congress as allowing the continued injury of the specific shareholders involved²⁹¹ and as causing an improper influence on the securities markets in general.²⁹²

288. See, e.g., *Zahn v. Transamerica Corp.*, 162 F.2d 36 (3d Cir. 1947). *Contra*, *Ostlind v. Ostlind Valve, Inc.*, 178 Ore. 161, 165 P.2d 779 (1946). These cases arose in the area of stockholder voting and directors' actions when the board was controlled by the majority shareholder. The majority shareholder was held to owe a fiduciary duty to minority shareholders.

289. See *Hearings on S. Res. Nos. 84, 56 & 97 Before the Senate Banking and Currency Comm.*, 73d Cong., 1st & 2d Sess., pt. 15, at 6557 (1934); Note, *American Standard, Inc. v. Crane Co.: The Insufficiency of Section 16(b)*, 22 BUFFALO L. REV. 889 (1973).

The original drafts of § 16(b) of the Securities Exchange Act of 1934 [hereinafter cited as 1934 Act], 15 U.S.C. § 78p(b) (1970), which barred only the improper use of insider information, were discarded because of the difficulty of proving the impropriety. See H.R. 7852, 73d Cong., 2d Sess. (1934); S. 2693, 73d Cong., 2d Sess. (1934). Other early drafts made it unlawful for any director, officer, or substantial shareholder to engage in short-swing trading. See *Hearings, supra* at 6430, 6955. These drafts were rejected as being overbroad. The final draft of § 16(b) sought to ease the overbreadness while at the same time avoiding the difficulties of proof inherent in the common law actions. See H.R. 9323, 73d Cong., 2d Sess. (1934).

290. For a list of abuses reported to Congress, see H.R. REP. NOS. 1383, 1838, 73d Cong., 2d Sess. (1934); S. REP. NOS. 792, 1455, 73d Cong., 2d Sess. (1934).

291. See *Reliance Elec. Co. v. Emerson Elec. Co.*, 404 U.S. 418, 428 n.2 (1972); *Heli-Coil Corp. v. Webster*, 352 F.2d 156 (3d Cir. 1965); *Blau v. Ogsbury*, 210 F.2d 426 (2d Cir. 1954); *Rattner v. Lehman*, 193 F.2d 564 (2d Cir. 1952); *Gratz v. Claughton*, 187 F.2d 46 (2d Cir.), *cert. denied*, 341 U.S. 920 (1951); *Colby v. Klune*, 178 F.2d 872 (2d Cir. 1949); *Shaw v. Dreyfus*, 172 F.2d 140 (2d Cir.), *cert. denied*, 337 U.S. 907 (1949); *Park & Tilford, Inc. v. Schulte*, 160 F.2d 984 (2d Cir.), *cert. denied*, 332 U.S. 761 (1947); *Lockheed Aircraft Corp. v. Campbell*, 110 F. Supp. 282 (S.D. Cal. 1953); *Steinberg v. Sharpe*, 95 F. Supp. 32 (S.D.N.Y. 1950), *aff'd*, 190 F.2d 82 (2d Cir. 1951); *Truncale v. Blumberg*, 80 F. Supp. 387 (S.D.N.Y. 1948), *appeal dismissed sub nom. Truncale v. Scully*, 182 F.2d 1021 (2d Cir. 1950).

292. See *Heli-Coil Corp. v. Webster*, 352 F.2d 156 (3d Cir. 1965); *Blau v. Ogsbury*, 210 F.2d 426 (2d Cir. 1954); *Rattner v. Lehman*, 193 F.2d 564 (2d Cir. 1952); *Gratz v. Claughton*, 187 F.2d 46 (2d Cir.), *cert. denied*, 341 U.S. 920 (1951); *Colby v. Klune*, 178 F.2d 872 (2d Cir. 1949); *Shaw v. Dreyfus*, 172 F.2d 140 (2d Cir.), *cert. denied*, 337 U.S. 907 (1949); *Park & Tilford, Inc. v. Schulte*, 160 F.2d 984 (2d Cir.), *cert. denied*, 332 U.S. 761 (1947); *Lockheed Aircraft Corp. v. Campbell*, 110 F. Supp. 282

In reaction to this situation, Congress approached the problem of protecting shareholders through two different avenues: first, in section 10(b)²⁹³ of the 1934 Act, by imposing on every buyer and seller of securities a duty to disclose material information;²⁹⁴ and second, in section 16(b)²⁹⁵ of the Act, by providing that insiders²⁹⁶ of any company

(S.D. Cal. 1953); *Truncale v. Blumberg*, 80 F. Supp. 387 (S.D.N.Y. 1948), *appeal dismissed sub nom. Truncale v. Scully*, 182 F.2d 1021 (2d Cir. 1950).

293. 15 U.S.C. § 78j(b) (1970). Although the SEC has promulgated sixteen rules under the authority granted to it in § 10(b), SEC rule 10b-5, 17 C.F.R. § 240.10b-5 (1974), is the most important in the present discussion. For a discussion of certain aspects of the rule, see part V *infra*.

294. Although § 10(b) and SEC rule 10b-5 do not explicitly provide for a private cause of action, it is now established that such a right is implied by the statute. *See Superintendent of Ins. v. Bankers Life & Cas. Co.*, 404 U.S. 6, 10 n.6 (1971); 6 L. Loss, *SECURITIES REGULATION* 3869-73 (2d ed. 1961, Supp. 1969) [hereinafter cited as *Loss*]; *cf. Tcherepnin v. Knight*, 389 U.S. 332 (1967); *J.I. Case Co. v. Borak*, 377 U.S. 426 (1964).

295. 15 U.S.C. § 78p(b) (1970). The section provides:

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

The section was held constitutional in *Gratz v. Claughton*, 187 F.2d 46 (2d Cir.), *cert. denied*, 341 U.S. 920 (1951); *Park & Tilford, Inc. v. Schulte*, 160 F.2d 984 (2d Cir.), *cert. denied*, 332 U.S. 761 (1947); *Smolowe v. Delendo Corp.*, 136 F.2d 231 (2d Cir.), *cert. denied*, 320 U.S. 751 (1943); *Stella v. Graham-Paige Motors Corp.*, 132 F. Supp. 100 (S.D.N.Y. 1955), *aff'd*, 232 F.2d 299 (2d Cir.), *cert. denied*, 352 U.S. 831 (1956).

296. Statutory insiders include "directors," "officers," and "beneficial owners" of the issuer. The term "director" is defined in § 3(a)(7) of the 1934 Act, 15 U.S.C. § 78c(a)(7) (1970), as "any director of a corporation or any person performing similar functions with respect to any organization, whether incorporated or unincorporated." The term "officer" is defined in rule 3b-2, 17 C.F.R. § 240.3b-2 (1974), as "a president, vice president, treasurer, secretary, comptroller, and any other person who performs for an issuer . . . functions corresponding to those performed by the foregoing." The term "beneficial owner" is defined in § 16(a) of the 1934 Act, 15 U.S.C. § 78p(a) (1970),

were liable to the company²⁹⁷ for profits realized from any purchase and sale²⁹⁸ or sale and purchase of the company's equity securities²⁹⁹ within a period of six months.³⁰⁰

While the general antifraud provisions of section 10(b) were meant to encompass all transactions in securities, the provisions of section 16(b) were aimed specifically at remedying the abuses arising from speculative trading by insiders.³⁰¹ Considered broadly remedial,³⁰²

as "[e]very person who is directly or indirectly the beneficial owner of more than 10 per centum of any class of any equity security (other than an exempted security) which is registered pursuant to section 12 of this title" See *Ellerin v. Massachusetts Mut. Life Ins. Co.*, 270 F.2d 259 (2d Cir. 1959).

297. This is basically a form of constructive trust. See *Adler v. Klawans*, 267 F.2d 840 (2d Cir. 1959); *Gratz v. Claughton*, 187 F.2d 46 (2d Cir.), *cert. denied*, 341 U.S. 920 (1951); *Volk v. Zlotoff*, 285 F. Supp. 650 (S.D.N.Y. 1961); *Blau v. Oppenheim*, 250 F. Supp. 881 (S.D.N.Y. 1966); *Perfect Photo, Inc. v. Grabb*, 205 F. Supp. 569 (E.D. Pa. 1962); *Cook & Feldman*, *supra* note 283.

298. The term "purchase" is defined in § 3(a)(13) of the 1934 Act, 15 U.S.C. § 78c(a)(13) (1970), to include "any contract to buy, purchase, or otherwise acquire." The term "sale" is defined in § 3(a)(14) of the 1934 Act, 15 U.S.C. § 78c(a)(14) (1970), to include "any contract to sell or otherwise dispose of." See notes 366-88 *infra* and accompanying text.

299. The term "equity security" is defined in § 3(a)(11) of the 1934 Act, 15 U.S.C. § 78c(a)(11) (1970), as

any stock or similar security; or any security convertible, with or without consideration, into such a security, or carrying any warrant or right to subscribe to or purchase such a security, or any such warrant or right; or any other security which the Commission shall deem to be of similar nature and consider necessary or appropriate, by such rules and regulations as it may prescribe in the public interest or for the protection of investors, to treat as an equity security.

See notes 317-22 *infra* and accompanying text.

300. See notes 361-65 *infra* and accompanying text. Section 16(b) provides that an action may be brought by a shareholder on behalf of the corporation. See *Blau v. Oppenheim*, 250 F. Supp. 881 (S.D.N.Y. 1966); *Cook & Feldman*, *supra* note 283; *Yourd*, *supra* note 283.

301. See 1934 Act § 16(b), 15 U.S.C. § 78p(b) (1970) (preamble); *Cook & Feldman*, *supra* note 283; *Yourd*, *supra* note 283; *Note*, *supra* note 283; 72 COLUM. L. REV. 1090 (1972); 25 U. FLA. L. REV. 412 (1973). See also *Blau v. Lamb*, 363 F.2d 507, 515 (2d Cir. 1966), *cert. denied*, 385 U.S. 1002 (1967); *Shaw v. Dreyfus*, 172 F.2d 140, 142 (2d Cir.), *cert. denied*, 337 U.S. 907 (1949); *Hearings on H.R. 7852 & H.R. 8720 Before the House Interstate and Foreign Commerce Comm.*, 73d Cong., 2d Sess. 85 (1934); *Hearings*, *supra* note 289, at 6557-59.

302. *Newmark v. RKO Gen., Inc.*, 425 F.2d 348 (2d Cir.), *cert. denied*, 400 U.S. 854 (1970); *Petteys v. Butler*, 367 F.2d 528, 532 (8th Cir. 1966), *cert. denied*, 385 U.S. 1006 (1967); *Adler v. Klawans*, 267 F.2d 840, 844 (2d Cir. 1959); *Gadsby & Treadway, Recent Developments Under Section 16(b) of the Securities Exchange Act of 1934*, 17 N.Y.L.F. 687 (1971); *Laufer, Effect of Section 16(b) of the Securities Exchange Act on Use of Options by Insiders*, 8 N.Y.L.F. 232 (1962); *Note*, *supra* note 283; 26 S.W.L.J. 792 (1972).

section 16(b) was termed a "crude rule of thumb"³⁰³ because liability was based on proof of objective factors and not on proof of intent or actual misuse of inside information.³⁰⁴ The statute's ease of application was meant to serve as a clear guide to insiders' conduct,³⁰⁵ and the statute's overbreadth was thought to be alleviated by the six-month limitation³⁰⁶ and the SEC's exemption power.³⁰⁷

Early judicial interpretations emphasized the objective nature of section 16(b) while deemphasizing the harshness that might arise from application of the statute to transactions or persons not meant to be covered by the Act. In *Park & Tilford, Inc. v. Schulte*³⁰⁸ the Second Circuit determined that the otherwise "unorthodox transaction"³⁰⁹ of a conversion of preferred into common stock was a "purchase" simply because by the conversion the holder "acquired"

303. *Hearings, supra* note 289, at 6557 (statement of Thomas Corcoran). See also *Newmark v. RKO Gen., Inc.*, 425 F.2d 348, 350 (2d Cir.), *cert. denied*, 400 U.S. 854 (1970); *Blau v. Lamb*, 363 F.2d 507 (2d Cir. 1966), *cert. denied*, 385 U.S. 1002 (1967); *Heli-Coil Corp. v. Webster*, 352 F.2d 156 (3d Cir. 1965); *Booth v. Varian Associates*, 334 F.2d 1, 5 (1st Cir. 1964), *cert. denied*, 379 U.S. 961 (1965); *Rheem Mfg. Co. v. Rheem*, 295 F.2d 473, 475 (9th Cir. 1961).

304. The "irrespective of any intention on the part of such [insider]" language of § 16(b) makes this clear. See *Hearings, supra* note 289, at 6557 (statement of Thomas Corcoran). See also *Bershad v. McDonough*, 428 F.2d 693, 696 (7th Cir. 1970), *cert. denied*, 400 U.S. 992 (1971); *Feder v. Martin Marietta Corp.*, 406 F.2d 260, 262 (2d Cir. 1969), *cert. denied*, 396 U.S. 1036 (1970); *Petteys v. Butler*, 367 F.2d 528, 532 (8th Cir. 1966), *cert. denied*, 385 U.S. 1006 (1967); *Blau v. Lamb*, 363 F.2d 507, 515 (2d Cir. 1966), *cert. denied*, 385 U.S. 1002 (1967); *Western Auto Supply Co. v. Gamble-Skogmo, Inc.*, 348 F.2d 736, 741 (8th Cir. 1965), *cert. denied*, 382 U.S. 987 (1966); *Adler v. Klawans*, 267 F.2d 840, 845 (2d Cir. 1959); *Alloys Unltd., Inc. v. Gilbert*, 319 F. Supp. 617, 618 (S.D.N.Y. 1970).

305. H.R. REP. NO. 1387, 73d Cong., 2d Sess. 13 (1934); S. REP. NO. 792, 73d Cong., 2d Sess. 5-6 (1934); see *Bershad v. McDonough*, 428 F.2d 693, 696 (7th Cir. 1970), *cert. denied*, 400 U.S. 992 (1971); *Blau v. Lamb*, 363 F.2d 507, 515 (2d Cir. 1966), *cert. denied*, 385 U.S. 1002 (1967); *Western Auto Supply Co. v. Gamble-Skogmo, Inc.*, 348 F.2d 736, 740 (8th Cir. 1965), *cert. denied*, 382 U.S. 987 (1966); *Rheem Mfg. Co. v. Rheem*, 295 F.2d 473, 475 (9th Cir. 1961); *Adler v. Klawans*, 267 F.2d 840, 846 (2d Cir. 1959); *Lewis v. Wells*, 325 F. Supp. 382, 385 (S.D.N.Y. 1971); *Perfect Photo, Inc. v. Grabb*, 205 F. Supp. 569, 571 (E.D. Pa. 1962); *Jefferson Lake Sulphur Co. v. Walet*, 104 F. Supp. 20, 25 (E.D. La. 1952), *aff'd*, 202 F.2d 433 (5th Cir.), *cert. denied*, 346 U.S. 820 (1953).

306. See *Reliance Elec. Co. v. Emerson Elec. Co.*, 404 U.S. 418, 422 (1972); *Bershad v. McDonough*, 428 F.2d 693, 696 (7th Cir. 1970), *cert. denied*, 400 U.S. 992 (1971); *Adler v. Klawans*, 267 F.2d 840, 845 (2d Cir. 1959).

307. *Heli-Coil Corp. v. Webster*, 352 F.2d 156, 165 (3d Cir. 1965).

308. 160 F.2d 984 (2d Cir.), *cert. denied*, 332 U.S. 761 (1947).

309. The term "unorthodox transaction" refers to the disposition or receipt of securities in a manner not ordinarily considered a purchase or sale. 2 Loss 1066-70.

stock within the meaning of section 3(a)(13)³¹⁰ of the 1934 Act. In another decision, the same court reasoned that the preamble to section 16(b) did not make the standard of liability subjective, but rather was intended to guide the SEC in performing its rule-making function and the courts in determining the statute's constitutionality.³¹¹ If the statute's application to a particular situation was considered harsh, the Third Circuit in *Heli-Coil Corp. v. Webster*³¹² thought that such harshness was to be alleviated through the Commission's rule-making powers and not by the courts.³¹³

The vast majority of courts, however, rejected these contentions and adopted a "subjective" or "pragmatic" approach³¹⁴ which limited section 16(b) liability in unorthodox cases to those transactions that "may serve as a vehicle for the evil which Congress sought to prevent."³¹⁵ Under this subjective approach, the statute is applied only when its use would serve its goals, because "where alternative constructions of the terms of § 16(b) are possible, those terms are to be given the construction that best serves the congressional purpose of curbing short-swing speculation by corporate insiders."³¹⁶ Although this approach has been used most often in determining whether a particular transaction is a "purchase" or "sale" within the meaning of section 16(b), it has also been used to determine whether the statute's substantive elements apply in borderline situations.

A. *The Substantive Elements of Section 16(b)*

Various tests are used by the courts to determine whether the substantive elements of section 16(b) liability exist within the particu-

310. 160 F.2d at 987.

311. *Smolowe v. Delendo Corp.*, 136 F.2d 231, 236 (2d Cir.), *cert. denied*, 320 U.S. 751 (1943).

312. 352 F.2d 156 (3d Cir. 1965).

313. *Id.* at 165. *Contra*, *Feder v. Martin Marietta Corp.*, 406 F.2d 260, 268 (2d Cir. 1969), *cert. denied*, 396 U.S. 1036 (1970); *Blau v. Lamb*, 363 F.2d 507, 519 (2d Cir. 1966), *cert. denied*, 385 U.S. 1002 (1967); *Roberts v. Eaton*, 212 F.2d 82 (2d Cir.), *cert. denied*, 348 U.S. 827 (1954); *Perlman v. Timberlake*, 172 F. Supp. 246, 254 (S.D. N.Y. 1959).

314. This approach is considered "subjective" or "pragmatic" because the courts apply the statutory terms only in those situations meant to be covered by the Act. In this manner, the alleged harsh results caused by overbroad definitions of statutory terms are alleviated.

315. *Kern County Land Co. v. Occidental Petroleum Corp.*, 411 U.S. 582, 594 (1973).

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

lar fact situation presented by a case. These statutory elements include "equity security," "beneficial owner," "director," "officer," "less than six months," "purchase" and "sale," and "profit."

1. "Equity Security"

Except for the limitations that the "equity security" must be a non-exempt security and that it must be registered pursuant to section 12 of the 1934 Act,³¹⁷ the term "equity security" has been defined broadly to include stock, similar securities whether or not issued by a corporation, securities convertible into stock or similar securities, and warrants and rights.³¹⁸ As a result of this broad definition, most courts have assumed, without discussion, that the security with which they were dealing was an "equity security."³¹⁹

Two collateral issues develop from the use of the term "equity security" in section 16(b). First, since the convertible security and the underlying stock into which it is convertible are both "equity securities," a problem arises when the receipt of the convertible security, the conversion into stock, and the subsequent sale of the stock all occur within a six-month period. Assuming that the transactions involved are all either "purchases" or "sales," it is questionable whether Congress meant the convertible security to be an "equity security" separate and distinct from the underlying stock into which it is converted. To define each security as an "equity security" would impose a hardship on the statutory insider.³²⁰ This anomaly prompted the Commission to enact rule 16b-9 which exempts "[a]ny acquisition or disposition of an equity security involved in the conversion of an equity security which . . . is convertible immediately or after a stated period of time into another equity security of the same issuer"³²¹

317. 15 U.S.C. § 78i (1970). The limitations are contained, respectively, in §§ 16 (b) and (a) of the 1934 Act, 15 U.S.C. §§ 78j(b), (a) (1970).

318. See 1934 Act § 3(a)(11), 15 U.S.C. § 78c(a)(11) (1970); SEC rule 3a11-1, 17 C.F.R. § 240.3a11-1 (1974).

319. For cases specifically applying § 3(a)(11), see *Bershad v. McDonough*, 428 F.2d 693, 698 (7th Cir. 1970), *cert. denied*, 400 U.S. 992 (1971) (option); *Chemical Fund, Inc. v. Xerox Corp.*, 377 F.2d 107, 110 (2d Cir. 1967) (convertible debenture); *Silverman v. Landa*, 306 F.2d 422, 424 (2d Cir. 1962) (puts and calls); *Shaw v. Dreyfus*, 172 F.2d 140, 142 (2d Cir.), *cert. denied*, 337 U.S. 907 (1949) (warrants); *Jefferson Lake Sulphur Co. v. Walet*, 104 F. Supp. 20, 23 (E.D. La. 1952), *aff'd*, 202 F.2d 433 (5th Cir.), *cert. denied*, 346 U.S. 820 (1953) (treasury stock).

320. The hardship results because the conversion would then be considered both a "sale" of the convertible security and a "purchase" of the underlying security.

321. 17 C.F.R. § 240.16b-9 (1974).

Secondly, section 16(b) defines liability in terms of the purchase and sale of "any equity security." A literal application of this requirement would hold an insider liable to the corporation for a purchase of stock and a subsequent sale of unrelated convertible debentures within a six-month period. Again, this would cause an anomalous result. For this reason, the courts require that the two transactions involve the same or related securities.³²²

2. Statutory Insiders

a. "Beneficial Owner"

The phrase "beneficial owner" in section 16(b) refers to section 16(a), which defines "beneficial owner" to include "[e]very person who is directly or indirectly the beneficial owner of more than 10 per centum of any class of any equity security . . ."³²³ In *Ellerin v. Massachusetts Mutual Life Insurance Co.*³²⁴ the Second Circuit held that each "series" of an issue of preferred stock was not a separate "class" for purposes of determining a beneficial owner's insider status.³²⁵ The court reached its decision by rejecting the use of the subjective approach as a guide to what is meant by an "insider," and instead defined the term "class" according to "the common usage of the day in the legal and financial worlds."³²⁶

In determining whether a person beneficially owns more than ten percent of any class of any equity security, courts regard the class as consisting of all outstanding, nonexempt, registered equity securities of that class, "exclusive of any securities of such class held by or for the account of the issuer or a subsidiary of the issuer."³²⁷ In addition, rule 16a-2(b)³²⁸ provides that a person may be a ten-percent beneficial owner of a class of convertible equity securities and, simultaneously, be a ten-percent beneficial owner of the equity security which may be acquired by exercise of the conversion and similar privileges.³²⁹

322. See, e.g., *Smolowe v. Delendo Corp.*, 136 F.2d 231, 237 n.13 (2d Cir.), cert. denied, 320 U.S. 751 (1943); *Yourd*, supra note 283, at 147.

323. 1934 Act § 16(a), 15 U.S.C. § 78p(a) (1970).

324. 270 F.2d 259 (2d Cir. 1959).

325. *Id.* at 262-63.

326. *Id.* at 261-62.

327. 1934 Act § 16(a), 15 U.S.C. § 78p(a) (1970).

328. 17 C.F.R. § 240.16a-2(b) (1974).

329. This is commonly referred to as the "hypothetical conversion" theory. See, e.g., *Chemical Fund, Inc. v. Xerox Corp.*, 377 F.2d 107, 110 (2d Cir. 1967); *American Standard, Inc. v. Crane Co.*, 346 F. Supp. 1153, 1170 (S.D.N.Y. 1971).

One of the more difficult problems in defining "beneficial owner" is determining when a person attains the status of a ten-percent beneficial owner. Section 16(b) by its terms is "not [to] 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." In *Stella v. Graham-Paige Motors Corp.*³³⁰ the court determined that a person is a ten-percent beneficial owner for purposes of the transaction which placed him over the ten-percent mark.³³¹ The *Stella* court reasoned that since the exemption clause in section 16(b) was subject to two possible constructions, the construction that best effectuated the congressional purpose of curbing abusive insider trading should be chosen.³³² The court reasoned that

[i]f the construction urged by defendant [that "at the time" means "prior to" rather than "simultaneously with"] is placed upon the exemption provision, it would be possible for a person to purchase a large block of stock, sell it out until his ownership was reduced to less than 10%, and then repeat the process, ad infinitum. A construction such as this would provide a way for the evasion of § 16(b) by principle stockholders
³³³

This construction of the exemption provision suggests that a person should also be considered a ten-percent beneficial owner for purposes of a concluding transaction in which the beneficial owner reduces his holdings to less than ten percent.³³⁴

b. "Director"

Even though the definition of "director" in section 3(a)(7)³³⁵ of the 1934 Act is broad, no judicial decision has considered the question of whether a particular person is a "director."³³⁶ Rather, the courts have

330. 104 F. Supp. 957 (S.D.N.Y. 1952).

331. *Id.* at 959-60. See *Stella v. Graham-Paige Motors Corp.*, 132 F. Supp. 100, 103 (S.D.N.Y. 1955), *aff'd*, 232 F.2d 299 (2d Cir.), *cert. denied*, 352 U.S. 831 (1956). But see *Provident Sec. Inv. Co. v. Foremost-McKesson, Inc.*, 506 F.2d 601 (9th Cir. 1974), *cert. granted*, 95 S. Ct. 1117 (1975). In its determination of *Provident*, the Supreme Court will have an opportunity to resolve the uncertainty in this area.

332. 104 F. Supp. at 959.

333. *Id.*

334. See *Cook & Feldman*, *supra* note 283, at 631. But see *Reliance Elec. Co. v. Emerson Elec. Co.*, 404 U.S. 418 (1972).

335. 15 U.S.C. § 78c(a)(7) (1970). See note 296 *supra*.

336. The courts, however, have held a person a "director" under a deputization theory. See, e.g., *Blau v. Lehman*, 368 U.S. 403 (1962); *Feder v. Martin Marietta Corp.*, 406

dealt with the problem of when a director is a statutory insider for section 16(b) purposes. The language of the statutory exemption³³⁷ refers only to beneficial owners. This distinction was emphasized in *Adler v. Klawans*,³³⁸ in which the Second Circuit held that a person is liable under section 16(b) if he was a director at the date of sale even if he was no longer a director at the date of purchase.³³⁹ The court reasoned that

[t]he statute itself, independent of its legislative history, seems to treat directors and officers as one category of "insiders" and 10% beneficial owners as another. There is, of course, a logical and practical basis for distinction. Generally, although there are important exceptions, in certain circumstances, 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."³⁴⁰

The *Adler* court avoided deciding whether rule 16a-10,³⁴¹ in conjunction with Form 4,³⁴² was a proper exercise of the SEC's power and found that the reporting rules of section 16(a) extended to a person who became a director after acquiring the securities. The same court, however, did reach the issue³⁴³ eleven years later. In

F.2d 260 (2d Cir. 1969), *cert denied*, 396 U.S. 1036 (1970); *Ratner v. Lehman*, 193 F.2d 564, 566 (2d Cir. 1952) (L. Hand, J., concurring); *Marquette Mfg. Co. v. Andreas*, 239 F. Supp. 962 (S.D.N.Y. 1965). Under this theory a person or firm is considered a director if an actual director was acting as an agent for that person or firm.

337. The pertinent language of § 16(b) is:

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 equity security involved

15 U.S.C. § 78p(b) (1970).

338. 267 F.2d 840 (2d Cir. 1959).

339. *Id.* at 845-46. See, e.g., *Perfect Photo, Inc. v. Grabb*, 205 F. Supp. 569, 571-72 (E.D. Pa. 1962); *Blau v. Allen*, 163 F. Supp. 702, 704 (S.D.N.Y. 1958). See also *Perfect Photo, Inc. v. Sentiff*, 205 F. Supp. 574 (E.D. Pa. 1962).

340. 267 F.2d at 845.

341. 17 C.F.R. § 240.16a-10 (1974). The rule provides:

Any transaction which has been or shall be exempted from the requirements of section 16(a) shall, insofar as it is otherwise subject to the provisions of section 16(b), be likewise exempted from section 16(b).

342. Form 4 is required to be filed by SEC rule 16a-1, 17 C.F.R. § 240.16a-1 (1974). Prior to October 20, 1969, however, when subsection (e) of the rule became effective, rule 16a-1 did not require a director to file Form 4 after his directorship ceased.

343. The courts have consistently held that they may review the propriety of a rule adopted by the Commission. See, e.g., *Feder v. Martin Marietta Corp.*, 406 F.2d 260, 268 (2d Cir. 1969), *cert. denied*, 396 U.S. 1036 (1970); *Greene v. Dietz*, 247 F.2d 689,

*Feder v. Martin Marietta Corp.*³⁴⁴ the court held that a person is liable under section 16(b) if he was a director at the time of purchase, even though he had resigned and was no longer a director at the time of sale. The court dealt with the Commission's exemption by stating:

To be sure, the congressional belief that inside information could be abused . . . is just as germane to the situation when a person is a director only at the time of purchase as when he is a director only at the time of the sale. For, in the case of a director who resigns his directorship before the sale it is possible for both the purchase and sale to have been unfairly motivated by insider knowledge; whereas if the purchase were made prior to the directorship only the sale could be motivated by inside information. Clearly, therefore, a "short swing" sale or purchase by a resigning director must be a transaction "comprehended within the purpose of" § 16(b), and to the extent [the Rule] exempts such a transaction from § 16(b) the Rule is invalid.³⁴⁵

c. "Officer"

Because the status of directors and officers is treated similarly for purposes of section 16(b), the applicable law of the timing of a director's status also applies to officers.³⁴⁶ Thus, the courts have stated that a person need only be an officer at the time of either the purchase or sale to be liable under section 16(b).

There is, however, some dispute as to who is an officer for purposes of section 16(b). Rule 3b-2³⁴⁷ defines "officer" as "a president, vice president, treasurer, secretary, comptroller, and any other person who performs for an issuer . . . functions corresponding to those performed by the foregoing officers." The Second Circuit has rejected a "constitutional" definition³⁴⁸ of rule 3b-2. Instead, in *Colby v.*

692-93 (2d Cir. 1957); *Perlman v. Timberlake*, 172 F. Supp. 246, 254-55 (S.D.N.Y. 1959). In fact, the courts have reviewed the propriety of a variety of rules. See, e.g., *Kornfield v. Eaton*, 327 F.2d 263 (2d Cir. 1964) (rule 16b-6); *Colby v. Klune*, 178 F.2d 872 (2d Cir. 1949) (rule 3b-2); *Volk v. Zlotoff*, 318 F. Supp. 864 (S.D.N.Y. 1970) (rule 16b-6); *Perlman v. Timberlake*, *supra* (rule 16b-3); *Lockheed Aircraft Corp. v. Campbell*, 110 F. Supp. 282 (S.D. Cal. 1953) (rule 3b-2); *Lockheed Aircraft Corp. v. Rathman*, 106 F. Supp. 810 (S.D. Cal. 1952) (same); *Blau v. Hodgkinson*, 100 F. Supp. 361 (S.D.N.Y. 1951) (rule 16b-6).

344. 406 F.2d 260 (2d Cir.), *cert. denied*, 396 U.S. 1036 (1970).

345. *Id.* at 268.

346. See *Levy v. Seaton*, 358 F. Supp. 1, 4 (S.D.N.Y. 1973); *Cook & Feldman*, *supra* note 283, at 632.

347. 17 C.F.R. § 240.3b-2 (1974).

348. The "constitutional definition" provides that a person would be an officer only when he is so designated by the corporation's by-laws.

Klune,³⁴⁹ that court defined “officer” in light of the purposes of section 16(b), stating:

[W]e construe “officer” . . . thus: It includes . . . a corporate employee performing important executive duties of such character that he would be likely, in discharging these duties, to obtain confidential information about the company’s affairs that would aid him if he engaged in personal market transactions. It is immaterial how his functions are labelled or how defined in the by-laws, or that he does or does not act under the supervision of some other corporate representative. . . .

. . . .

. . . Under that Rule as we interpret it, it does not matter whether or how the by-laws of this particular company define the duties of such officers. The question is what this particular employee was called upon to do in this particular company, *i.e.*, the relation between his authorized activities and those of this corporation. Again, under this Rule, it is not decisive whether or not some other person supervised his work.³⁵⁰

Three years after this decision, the Second Circuit’s “subjective approach” was specifically repudiated by the District Court for the Southern District of California in *Lockheed Aircraft Corp. v. Rathman*.³⁵¹ The *Rathman* court, after finding that rule 3b-2 was valid, held that an assistant treasurer of Lockheed was not an officer because he merely assisted the actual treasurer in the performance of his functions, and because Lockheed did not consider him an officer.³⁵² One year later, in *Lockheed Aircraft Corp. v. Campbell*,³⁵³ the same court refused to apply either the “subjective” test of *Colby* or the “objective” test of *Rathman*. The *Campbell* court found, however, that Campbell, who served both as assistant secretary and assistant treasurer of Lockheed, was not an officer simply because he did not perform the functions that the secretary and treasurer of Lockheed performed.³⁵⁴

3. “Less Than Six Months”

In order for an insider to be liable under section 16(b), the purchase and sale must occur within “any period of less than six months.” Although a majority of the courts have assumed that six months is the outer

349. 178 F.2d 872 (2d Cir. 1949).

350. *Id.* at 873, 875 (footnote omitted).

351. 106 F. Supp. 810 (S.D. Cal. 1952).

352. *Id.* at 813.

353. 110 F. Supp. 282 (S.D. Cal. 1953).

354. *Id.* at 285.

limit of liability,³⁵⁵ the statutory language mandates otherwise, and the Second Circuit has agreed with this literal interpretation.³⁵⁶

The six-month period represents a balance struck between the need to deter short-swing speculation and the need to avoid unduly inhibiting long-term corporate investment.³⁵⁷ Indeed, the Ninth Circuit in *Blau v. Max Factor & Co.*³⁵⁸ used this statutory policy as a basis for determining that a particular exchange was not a "sale." The court was concerned with the sale of stock made by family members of a closely held corporation which had been obtained in an exchange the previous month. With respect to the purpose behind the six-month period, the court stated:

Appellees' investment commitment in Max Factor & Co. was a long term one, undertaken . . . many years prior to their exchange of Common for Class A. The exchange of Class A for Common did not interrupt the continuity of appellees' investment: it did not increase or decrease the amount invested, or alter in any way the risk assumed long years before. Moreover, since there was no speculative advantage in holding Class A rather than Common, the exchange conferred no opportunity for speculative profit which appellees did not already enjoy. Thus, appellees made only one investment decision in the six months' period—the decision to terminate their long-term investment by sale. The exchange was in reality only a step in the process of sale³⁵⁹

4. "Purchase" and "Sale"

The terms "purchase" and "sale" are broadly defined by the 1934 Act.³⁶⁰ The application of these definitions to particular transactions,

355. See, e.g., *B.T. Babbitt, Inc. v. Lachner*, 332 F.2d 255, 258 (2d Cir. 1964); *Adler v. Klawans*, 267 F.2d 840, 845 (2d Cir. 1959).

356. *Smolowe v. Delendo Corp.*, 136 F.2d 231, 235 (2d Cir.), cert. denied, 320 U.S. 751 (1943); *Stella v. Graham-Paige Motors Corp.*, 132 F. Supp. 100, 103 (S.D.N.Y. 1955), aff'd, 232 F.2d 299 (2d Cir.), cert. denied, 352 U.S. 831 (1956). The court in *Stella* stated that "[t]o be less than 6 months the statutory period must be 6 months minus one full period from midnight to midnight since the law does not take into account fractions of a day." *Id.* at 104.

357. S. REP. NO. 792, 73d Cong., 2d Sess. 6 (1934); see *Blau v. Max Factor & Co.*, 342 F.2d 304, 308 (9th Cir.), cert. denied, 382 U.S. 892 (1965); *Adler v. Klawans*, 267 F.2d 840, 845 (2d Cir. 1959).

358. 342 F.2d 304 (9th Cir.), cert. denied, 382 U.S. 892 (1965).

359. *Id.* at 308 (footnote omitted).

360. For the definition of "purchase," see 1934 Act § 3(a)(13), 15 U.S.C. § 78c(a)(13) (1970). For the definition of "sale," see *id.* § 3(a)(14), 15 U.S.C. § 78c(a)(14) (1970). See note 298 *supra*.

therefore, would seem to cause little difficulty. Nonetheless, the opposite has proven true. The courts have had great difficulty deciding whether a particular transaction is a "purchase" or "sale" and determining the exact time a particular "purchase" or "sale" occurred. This difficulty has arisen because "purchase" and "sale" have a broader definition in the 1934 Act than in common usage.

Unlike their counterparts in the Securities Act of 1933,³⁶¹ the definitions of "purchase" and "sale" under the 1934 Act contain no concept of either volition or receipt of value. The courts, however, have been quick to attach both of these concepts to the definitions of "purchase" and "sale" under the 1934 Act. Two cases have held that a bona fide gift does not constitute a sale because of the absence of a receipt of value,³⁶² and it has been intimated that the receipt or disposal of securities by devise would not constitute a "purchase" or "sale" for the same reason.³⁶³ Finally, the disposition of shares pursuant to the rescission of a contract has been held not to constitute a "sale" because there was an absence of volition.³⁶⁴

Typical transactions involving the voluntary disposition or receipt of securities for value, therefore, have caused the courts little concern. Instead, the courts have disagreed about whether "unorthodox" transactions³⁶⁵ such as mergers,³⁶⁶ corporate reorganizations,³⁶⁷ conver-

361. Section 2(3) of the Securities Act of 1933 [hereinafter cited as 1933 Act], 15 U.S.C. § 77b(3) (1970), defines "sale" to include "every contract of sale or disposition of a security or interest in a security, for value." The term "purchase" is not used in the 1933 Act. Instead, that Act uses the phrase "offer to buy," which is defined in § 2(3) to include any disposition of a security "for value."

362. *Shaw v. Dreyfus*, 172 F.2d 140, 142 (2d Cir.), cert. denied, 337 U.S. 907 (1949); *Truncale v. Blumberg*, 80 F. Supp. 387, 391 (S.D.N.Y. 1948), appeal dismissed sub nom. *Truncale v. Scully*, 182 F.2d 1021 (2d Cir. 1950). The *Truncale* court rejected the argument that the tax benefit that arises from a bona fide gift gives the transaction value.

363. *Truncale v. Blumberg*, 80 F. Supp. 387, 390 (S.D.N.Y. 1948), appeal dismissed sub nom. *Truncale v. Scully*, 182 F.2d 1021 (2d Cir. 1950).

364. *Kahausky v. Emerson Radio & Phonograph Corp.*, 184 F. Supp. 90 (S.D.N.Y. 1960). See also *Alloys Unltd., Inc. v. Gilbert*, 319 F. Supp. 617 (S.D.N.Y. 1970); *Blau v. Allen*, 163 F. Supp. 702 (S.D.N.Y. 1958). *Contra*, *Western Auto Supply Co. v. Gamble-Skogmo, Inc.*, 348 F.2d 736 (8th Cir. 1965), cert. denied, 382 U.S. 987 (1966).

365. The term "unorthodox transaction" was used initially by Professor Loss. 2 Loss 1066-70.

366. Two cases that have found a "merger" covered by the 1934 Act are *Newmark v. RKO Gen., Inc.*, 425 F.2d 348 (2d Cir.), cert. denied, 400 U.S. 854 (1970), and *Marquette Cement Mfg. Co. v. Andreas*, 239 F. Supp. 962 (S.D.N.Y. 1965). In *Newmark*, RKO General sought to gain control of Central Airlines by making a tender offer to

sions,³⁶⁸ stock reclassifications,³⁶⁹ intracorporate exchanges,³⁷⁰ and the

Central's shareholders. Central and Frontier Airlines countered by entering into a defensive merger. At the time the merger agreement was made, RKO owned 56% of Frontier's common stock. RKO's purchase contracts were executed approximately two weeks before the exchange pursuant to the merger took place. The court, applying the subjective, possibility-of-speculative-abuse test, found that the exchange constituted a "sale" because RKO's relationship to Frontier placed it in a position where it "could have reaped a speculative profit" from the unfair use of inside information. 425 F.2d at 353-54 (emphasis original). In *Marquette* the court, although suggesting that it was applying the subjective test, held that an exchange pursuant to a merger agreement was a "purchase" because the transaction resembled an ordinary cash transaction. 239 F. Supp. at 966.

SEC rule 16b-7, 17 C.F.R. § 240.16b-7 (1974), now exempts from § 16(b) mergers in which 85% of the equity securities of the merged company are owned by the surviving company. It is interesting to note that SEC rule 145 under the 1933 Act, 17 C.F.R. § 230.145 (1974), which became effective on January 1, 1973, makes mergers "sales" under the 1933 Act for purposes of the prospectus requirement, so long as the merger agreement is submitted for the vote or consent of the security holders. The submission requirement was thought to be necessary to meet the judicially imposed requirement that some element of volition be present. See 1 Loss 512-46 (Supp. 1969). Prior to the adoption of SEC rule 145, SEC rule 133 provided that a merger was not a "sale." Rule 133 was rescinded because the SEC decided that a merger is a "sale" under § 2(3) of the 1933 Act. See SEC Securities Act Release No. 5012 (Oct. 18, 1972).

367. In *Blau v. Hodgkinson*, 100 F. Supp. 361 (S.D.N.Y. 1951), the court, applying the objective test, held that the exchange of stock in a subsidiary for stock in the parent was a "purchase" of the stock in the parent. The court stated that the "[d]efendants did not own the common stock in question before they exercised their option to convert; they did afterward. Therefore they acquired the stock, within the meaning of the Act." *Id.* at 373. See also *Provident Sec. Inv. Co. v. Foremost-McKesson, Inc.*, 506 F.2d 601 (9th Cir. 1974), *cert. granted*, 95 S. Ct. 1117 (1975) (corporate liquidation subject to section 16(b) scrutiny).

368. For cases holding that the receipt of shares pursuant to a conversion of a convertible security is a "purchase," see *Heli-Coil Corp. v. Webster*, 352 F.2d 156 (3d Cir. 1965) (applying objective test); *Park & Tilford, Inc. v. Schulte*, 160 F.2d 984 (2d Cir.), *cert. denied*, 332 U.S. 761 (1947) (same). For cases holding that the receipt of shares pursuant to a conversion of a convertible security is not a "purchase," see *Petteys v. Butler*, 367 F.2d 528 (8th Cir. 1966), *cert. denied*, 385 U.S. 1006 (1967) (applying subjective test); *Blau v. Lamb*, 363 F.2d 507 (2d Cir. 1966), *cert. denied*, 385 U.S. 1002 (1967) (same); *Ferraiolo v. Newman*, 259 F.2d 342 (6th Cir. 1958), *cert. denied*, 359 U.S. 927 (1959) (same); *Lynan v. Livingston*, 276 F. Supp. 104 (D. Del. 1967) (same).

Although the exact holdings of these cases have been mooted by the adoption, in 1966, of SEC rule 16b-9, 17 C.F.R. § 240.16b-9 (1974), they continue to be important because of the approaches used by the courts. The most significant approach to arise from conversion cases is the "economic equivalents" test. Under this test

there is no "sale" within the meaning of § 16(b) when one type of equity security is converted into another if the securities are substantial economic equivalents and the conversion is "involuntary" in the sense that if there is no con-

exercise of warrants³⁷¹ and options³⁷² are covered by the Act. Many

version the owner will suffer substantial economic loss.

Heli-Coil Corp. v. Webster, *supra* at 163. When the security converted and the security received are considered merely different forms of the same participation in the issuer, the absence of any possibility of speculative abuse is said to exist. *See* *Blau v. Lamb*, *supra* at 521; *Ferraiolo v. Newman*, *supra* at 346. *Contra*, *Heli-Coil Corp. v. Webster*, *supra* at 164-65. And when the sale of the converted security would net a lesser amount than the fair market value of the securities received, the conversion is deemed involuntary, or "compelled as a matter of economic necessity." *Lynam v. Livingston*, *supra* at 106. *See also* *Ferraiolo v. Newman*, *supra* at 346. *Contra*, *Heli-Coil Corp. v. Webster*, *supra* at 168; *Park & Tilford, Inc. v. Schulte*, *supra* at 987. The conversion after the securities had been called, rather than before, was held to be the distinguishing factor in *Lynam*. *See also* note 366 *supra*.

369. In *Roberts v. Eaton*, 212 F.2d 82 (2d Cir.), *cert. denied*, 348 U.S. 827 (1954), the defendant and his family owned 97% of the common stock of Old Town Corporation in 1947. By 1952 the family's holdings were reduced to 45.9%. In that year the directors of Old Town proposed a stock reclassification, which was authorized by holders of over two-thirds of the outstanding shares as required by state law. Within six months after receiving his new shares pursuant to the reclassification, the defendant sold his newly acquired shares. The court, applying the subjective test, held that the receipt of stock pursuant to the reclassification was not a "purchase." The court reasoned that the cumulative effect of the following factors demonstrated that there was no possibility of speculative abuse in the transaction: (1) the defendant had no control over the reclassification, since shareholder approval by two-thirds of the outstanding shares was needed; (2) the acquisition and sale were disclosed; (3) the defendant received securities that had no pre-existing market value, and the market mechanisms that gave securities value were of general knowledge; and (4) the defendant continued his interest in the same company. *Id.* at 85-86.

370. In *Blau v. Lamb*, 363 F.2d 507 (2d Cir.), *cert. denied*, 385 U.S. 1002 (1966), a corporation that was wholly owned by the defendant, pursuant to merger plans, transferred shares of Air-Way Industries to a third corporation, over which the defendant had 97% control. The court held that the transaction did not constitute a "purchase" by the third corporation, but was merely a transfer between corporate pockets. *Id.* at 526.

In *Blau v. Mission Corp.*, 212 F.2d 77 (2d Cir.), *cert. denied*, 347 U.S. 1016 (1954), Mission Corporation, pursuant to a plan to take over Tide Water Associated Oil Company, acquired over 10% of Tide Water's common stock. Thereafter, Mission transferred those shares to its wholly owned subsidiary, Mission Development Co., and within six months again began purchasing shares of Tide Water. After finding that Mission, "by virtue of its absolute control of Development," was an insider of Tide Water, the court held that the exchange was not a "sale," but "a mere transfer between corporate pockets." *Id.* at 80.

371. For a case holding that the director-stockholder's receipt of a warrant, issued to all common shareholders of record, was not a "purchase," see *Shaw v. Dreyfus*, 172 F.2d 140, 142 (2d Cir.), *cert. denied*, 337 U.S. 907 (1949) (applying subjective test and receipt of value-volition concepts). *See also* *Truncale v. Blumberg*, 80 F. Supp. 387 (S.D.N.Y. 1948), *appeal dismissed sub nom.* *Truncale v. Scully*, 182 F.2d 1021 (2d Cir. 1950) (discussing subjective and objective approaches without coming to resolution).

For cases holding that the receipt of stock pursuant to the exercise of a warrant is a "purchase," see *Shaw v. Dreyfus*, *supra* at 142; *Blau v. Hodgkinson*, 100 F. Supp. 361, 373 (S.D.N.Y. 1951) (applying objective approach).

decisions have applied the "objective" test, in which the broad statutory definitions are applied literally to each transaction.³⁷³ The great majority of courts, however, have applied the pragmatic, "subjective" test.³⁷⁴ Under this test, the transaction in question is studied to determine whether it³⁷⁵ could possibly lend itself to the kinds of speculative

372. For a case holding that an option contract is a "contract for sale," see *Bershad v. McDonough*, 428 F.2d 693, 697-98 (7th Cir. 1970), *cert. denied*, 400 U.S. 992 (1971) (applying subjective test). *Contra*, *Silverman v. Landa*, 306 F.2d 422, 424 (2d Cir. 1962) ("[S]hould the options lapse unexercised . . . no change in . . . beneficial ownership of the underlying security would occur. And, most importantly, any change would occur at the pleasure of the optionee.").

For cases holding that the exercise of an option is a "purchase," see *Blau v. Ogsbury*, 210 F.2d 426, 427 (2d Cir. 1954); *Volk v. Zlotoff*, 285 F. Supp. 650, 657 (S.D.N.Y. 1968). See also *B.T. Babbitt, Inc. v. Lachner*, 332 F.2d 255 (2d Cir. 1964) (assuming exercise is a "purchase"); *Jefferson Lake Sulphur Co. v. Walet*, 104 F. Supp. 20 (E.D. La. 1952), *aff'd*, 202 F.2d 433 (5th Cir.), *cert. denied*, 346 U.S. 820 (1953) (same).

SEC rule 16b-3, 17 C.F.R. § 240.16b-3 (1974), was enacted to exempt stock acquired pursuant to nontransferable options. The court in *Greene v. Dietz*, 247 F.2d 689 (2d Cir. 1957), cast doubt on the validity of the rule. The rule was held invalid in *Perlman v. Timberlake*, 172 F. Supp. 246, 258 (S.D.N.Y. 1959). The *Perlman* court stated that the Commission had overstepped its powers in enacting the rule, since the transactions exempted were surrounded by too much potential for abuse. Cf. *B.T. Babbitt, Inc. v. Lachner*, *supra* at 259. The rule was amended in 1964 and now exempts the acquisition of shares of stock received pursuant to certain corporate option plans.

373. For cases applying the "objective" test, see *Heli-Coil Corp. v. Webster*, 352 F.2d 156 (3d Cir. 1965); *Western Auto Supply Co. v. Gamble-Skogmo, Inc.*, 348 F.2d 736 (8th Cir. 1965), *cert. denied*, 382 U.S. 987 (1966); *Park & Tilford, Inc. v. Schulte*, 160 F.2d 984 (2d Cir.), *cert. denied*, 332 U.S. 761 (1947); *Smolowe v. Delendo Corp.*, 136 F.2d 231 (2d Cir.), *cert. denied*, 320 U.S. 751 (1943); *Volk v. Zlotoff*, 285 F. Supp. 650 (S.D.N.Y. 1968); *Lynam v. Livingston*, 276 F. Supp. 104 (D. Del. 1967); *Blau v. Hodgkinson*, 100 F. Supp. 361 (S.D.N.Y. 1951); *Truncale v. Blumberg*, 80 F. Supp. 387 (S.D.N.Y. 1948), *appeal dismissed sub nom. Truncale v. Scully*, 182 F.2d 1021 (2d Cir. 1950). See also *Petteys v. Butler*, 367 F.2d 528, 538 (8th Cir. 1966), *cert. denied*, 385 U.S. 1006 (1967) (dissent by then Judge Blackmun encouraging application of "objective" approach because transaction fell within literal definition of "purchase").

374. For cases applying the "subjective" test, see *Newmark v. RKO Gen., Inc.*, 425 F.2d 348 (2d Cir.), *cert. denied*, 400 U.S. 854 (1970); *Petteys v. Butler*, 367 F.2d 528 (8th Cir. 1966), *cert. denied*, 385 U.S. 1006 (1967); *Blau v. Lamb*, 363 F.2d 507 (2d Cir. 1966), *cert. denied*, 385 U.S. 1002 (1967); *Blau v. Max Factor & Co.*, 342 F.2d 304 (9th Cir.), *cert. denied*, 382 U.S. 892 (1965); *Ferraiolo v. Newman*, 259 F.2d 342 (6th Cir. 1958), *cert. denied*, 359 U.S. 927 (1959); *Roberts v. Eaton*, 212 F.2d 82 (2d Cir.), *cert. denied*, 348 U.S. 827 (1954); *Blau v. Mission Corp.*, 212 F.2d 77 (2d Cir.), *cert. denied*, 347 U.S. 1016 (1954); *Shaw v. Dreyfus*, 172 F.2d 140 (2d Cir.), *cert. denied*, 337 U.S. 907 (1949); *Alloys Unltd., Inc. v. Gilbert*, 319 F. Supp. 617 (S.D.N.Y. 1970); *Marquette Cement Mfg. Co. v. Andreas*, 239 F. Supp. 962 (S.D.N.Y. 1965). See also *Bershad v. McDonough*, 428 F.2d 693 (7th Cir. 1970), *cert. denied*, 400 U.S. 992 (1971); *Blau v. Ogsbury*, 210 F.2d 426 (2d Cir. 1954).

375. It is important to emphasize that in applying the subjective test the courts look only to the transaction and the circumstances surrounding it to determine whether a pos-

abuse that section 16(b) was designed to prevent. The rationale behind the subjective test was best outlined in *Blau v. Lamb*,³⁷⁶ in which the Second Circuit stated:

It is quite apparent that because of the broad definitions of "purchase" and "sale" imported into Section 16(b), this section may be applied not only to routine cash purchases and sales of equity securities but also may be applied to acquisitions and dispositions of equity securities in transactions involving conversions, options, stock warrants, reclassifications and the like. . . . [S]ome of these transactions may not lend themselves in any way to an unfair use of inside information by corporate insiders.³⁷⁷

All the reported cases have adopted similar "pragmatic" reasoning in determining *when* a particular transaction occurred.³⁷⁸ These cases have attempted to determine which contended date of purchase or sale most easily lent itself to speculative abuse of inside information. As the First Circuit noted in *Booth v. Varian Associates*,³⁷⁹

The question [of when the transaction occurred is] one of balancing the respective advantages and disadvantages of each contended for "purchase" date and determining which one, if held to be the date of purchase, would be more likely to lend itself to the abuses the statute was designed to protect against.³⁸⁰

All of the courts, in applying this "subjective" test, have followed the conclusion of *Blau v. Ogsbury*³⁸¹ that the transaction is deemed to take place when the insider is "irrevocably liable" to purchase or sell a fixed

sibility of speculative abuse existed. *See, e.g.*, cases cited note 374 *supra*. *But see* *Bershad v. McDonough*, 428 F.2d 693, 697-98 (7th Cir. 1970), *cert. denied*, 400 U.S. 992 (1971) (stock options may be used as "tool" for speculative abuse); *cf.* *Petteys v. Butler*, 367 F.2d 528, 536 (8th Cir. 1966), *cert. denied*, 385 U.S. 1006 (1967) ("As a general proposition, conversions of equity securities are not transactions which normally lend themselves to shortswing speculation.").

376. 363 F.2d 507 (2d Cir. 1966), *cert. denied*, 385 U.S. 1002 (1967).

377. *Id.* at 516 (footnote omitted). *See also* *Petteys v. Butler*, 367 F.2d 528, 533 (8th Cir. 1966), *cert. denied*, 385 U.S. 1006 (1967). *But see* *Heli-Coil Corp. v. Webster*, 352 F.2d 156, 165 (3d Cir. 1965) ("[W]e are of the opinion . . . that it was the intention of Congress in enacting § 16(b) to obviate any necessity for a search of motives of the insider or require an investigation of whether or not his actions were animated by inside information to gain a speculative profit.").

378. The determination of when a particular transaction took place is germane to the issues of whether the transaction took place within the six-month period and how much profit the insider realized, since that date will control for stock valuation purposes.

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

380. *Id.* at 4. *See also* *Blau v. Ogsbury*, 210 F.2d 426, 427 (2d Cir. 1954).

381. 210 F.2d 426 (2d Cir. 1954).

quantity of stock at a fixed price.³⁸² Thus, these courts uniformly have rejected what normally would be considered the date the transaction took place—that is, the date the securities actually were exchanged for value.

5. "Profit"

As with the question of determining whether there has been a "purchase" or "sale," routine transactions cause few problems in computing damages: the "profit" equals the cost less the proceeds.³⁸³ Further, since shares of the same class of stock are fungible, tracing has been deemed unnecessary,³⁸⁴ and the courts have unanimously chosen to follow the test for computation of profit first delineated in *Smolowe v. Delendo Corp.*:³⁸⁵ the "lowest price in-highest price out" method.³⁸⁶ Under this method, profit is computed by matching the highest sales price with the lowest purchase price within six months, the next highest sales price with the next lowest purchase price within six months, and so on, until all the shares are included in the computation. Then, the differences between the amounts matched are added together to determine the total profit.

382. *Id.* at 427. For cases following *Ogsbury*, see *Bershad v. McDonough*, 428 F.2d 693, 698 (7th Cir. 1970), *cert. denied*, 400 U.S. 992 (1971); *Booth v. Varian Associates*, 334 F.2d 1, 4 (1st Cir. 1964), *cert. denied*, 379 U.S. 961 (1965); *Silverman v. Landa*, 306 F.2d 422, 424 n.4 (2d Cir. 1962); *Marquette Cement Mfg. Co. v. Andreas*, 239 F. Supp. 962, 967 (S.D.N.Y. 1965); *Stella v. Graham-Paige Motors Corp.*, 132 F. Supp. 100, 104 (S.D.N.Y. 1955), *aff'd*, 232 F.2d 299 (2d Cir.), *cert. denied*, 352 U.S. 831 (1956).

383. *See, e.g., Heli-Coil Corp. v. Webster*, 352 F.2d 156, 167 (3d Cir. 1965); *Blau v. Mission Corp.*, 212 F.2d 77, 81 (2d Cir.), *cert. denied*, 347 U.S. 1016 (1954); *Stella v. Graham-Paige Motors Corp.*, 132 F. Supp. 100, 106-07 (S.D.N.Y. 1955), *aff'd*, 232 F.2d 299 (2d Cir.), *cert. denied*, 352 U.S. 831 (1956).

384. *See, e.g., Western Auto Supply Co. v. Gamble-Skogmo, Inc.*, 348 F.2d 736, 742-43 (8th Cir. 1965), *cert. denied*, 382 U.S. 987 (1966); *Gratz v. Claughton*, 187 F.2d 46, 50 (2d Cir.), *cert. denied*, 341 U.S. 920 (1951); *Smolowe v. Delendo Corp.*, 136 F.2d 231, 238 (2d Cir.), *cert. denied*, 320 U.S. 751 (1943). *See also Alloys Unltd., Inc. v. Gilbert*, 319 F. Supp. 617, 619 (S.D.N.Y. 1970) (suggesting that tracing may be necessary where some shares were registered and some not).

385. 136 F.2d 231 (2d Cir.), *cert. denied*, 320 U.S. 751 (1943).

386. For cases applying the "lowest price in-highest price out" method, see *Western Auto Supply Co. v. Gamble-Skogmo, Inc.*, 348 F.2d 736 (8th Cir. 1965), *cert. denied*, 382 U.S. 987 (1966); *Gratz v. Claughton*, 187 F.2d 46 (2d Cir.), *cert. denied*, 341 U.S. 920 (1951); *Park & Tilford, Inc. v. Schulte*, 160 F.2d 984 (2d Cir.), *cert. denied*, 332 U.S. 761 (1947); *Volk v. Zlotoff*, 285 F. Supp. 650 (S.D.N.Y. 1968); *Arkansas La. Gas Co. v. W.R. Stephens Inv. Co.*, 141 F. Supp. 841 (W.D. Ark. 1956); *Steinberg v. Sharpe*, 95 F. Supp. 32 (S.D.N.Y. 1950), *aff'd*, 190 F.2d 82 (2d Cir. 1951).

This strict rule for computing profits was adopted because, more than other possible techniques in which sales are matched with purchases, the rule serves to promote full compliance with the purpose of the 1934 Act³⁸⁷ by maximizing the profits that can be recovered.³⁸⁸ In fact, the insider is often required to disgorge to the corporation "profits" on some of the securities he has sold even though he has sustained an overall loss.³⁸⁹

The most difficult problems in computing profits have arisen when one of the transactions involved an option, a convertible security, or a similar security. One court has set the cost of the stock received upon exercise of the option at "the exercise price of the option plus the value of the option *on the day that it accrued* as fixed by the employment agreement under the terms of which it accrued."³⁹⁰ The court's adoption of the accrual date for valuation purposes has been followed in a number of decisions, even in light of the court's seemingly contradictory adoption of the exercise date for the determination of the six-month requirement.³⁹¹ Today, many of these computation problems have been alleviated by rule 16b-6, which limits the calculation of profit in certain option transactions to "the difference between the proceeds of sale and the lowest market price of any security of the same class within six months before or after the date of sale."³⁹²

The final issue concerning the computation of profits is whether certain consequential receipts and costs should be considered in the cal-

387. For an interesting case applying the statutory purpose of strict compliance, see *Jefferson Lake Sulphur Co. v. Walet*, 104 F. Supp. 20 (E.D. La. 1952), *aff'd*, 202 F.2d 433 (5th Cir.), *cert. denied*, 346 U.S. 820 (1953) (court refused to adopt defendant's argument that since he was domiciled in community property state he need disgorge only one-half of his profits).

388. See *Gratz v. Claughton*, 187 F.2d 46, 51 (2d Cir.), *cert. denied*, 341 U.S. 920 (1951); *Smolowe v. Delendo Corp.*, 136 F.2d 231, 239 (2d Cir.), *cert. denied*, 320 U.S. 751 (1943).

389. *Gratz v. Claughton*, 187 F.2d 46 (2d Cir.), *cert. denied*, 341 U.S. 920 (1951).

390. *Steinberg v. Sharpe*, 95 F. Supp. 32, 34 (S.D.N.Y. 1950), *aff'd*, 190 F.2d 82 (2d Cir. 1951) (emphasis original).

391. See, e.g., *B.T. Babbitt, Inc. v. Lachner*, 332 F.2d 255 (2d Cir. 1964); *Volk v. Zlotoff*, 318 F. Supp. 864 (S.D.N.Y. 1970); *Blau v. Hodgkinson*, 100 F. Supp. 361 (S.D.N.Y. 1951).

392. 17 C.F.R. § 240.16b-6 (1974). The adoption of SEC rule 16b-6 has been held valid in a number of cases. See, e.g., *Kornfield v. Eaton*, 327 F.2d 263, 265 (2d Cir. 1964); *Volk v. Zlotoff*, 318 F. Supp. 864, 867 (S.D.N.Y. 1970); *Blau v. Hodgkinson*, 100 F. Supp. 361, 371 (S.D.N.Y. 1951).

culatation. The cases have unanimously held that the allowance of interest lies in the discretion of the court.³⁹³ Whether interest will be allowed is based upon the equities of the case;³⁹⁴ if it is allowed, interest begins running from the date the profit was realized.³⁹⁵ On the other hand, the courts have split on whether dividends should be considered part of the profit realized.³⁹⁶ One court based its allowance of dividends on whether there was a possibility of insider manipulation of the dividend.³⁹⁷ Another court has held that the inclusion in the damages of a "control premium" was justified,³⁹⁸ although this result has been severely criticized.³⁹⁹

6. Summary

These decisions illustrate that the courts have viewed each of the substantive elements of section 16(b) differently. Most courts have followed the pragmatic, "subjective" approach in construing the following elements in a particular transaction: "beneficial owner" (for purposes of the opening transaction), "officer," "purchase" and "sale," and "profit." On the other hand, most courts have followed the

393. *Western Auto Supply Co. v. Gamble-Skogmo, Inc.*, 348 F.2d 736, 744 (8th Cir. 1965), *cert. denied*, 382 U.S. 987 (1966); *Magida v. Continental Can Co.*, 231 F.2d 843, 848 (2d Cir.), *cert. denied*, 351 U.S. 972 (1956); *Lewis v. Wells*, 325 F. Supp. 382, 387 (S.D.N.Y. 1971); *Marquette Cement Mfg. Co. v. Andreas*, 239 F. Supp. 962, 968 (S.D.N.Y. 1965).

394. *Blau v. Lehman*, 368 U.S. 403, 414 (1962); *Western Auto Supply Co. v. Gamble-Skogmo, Inc.*, 348 F.2d 736, 744 (8th Cir. 1965), *cert. denied*, 382 U.S. 987 (1966) (allowed interest); *Lewis v. Wells*, 325 F. Supp. 382, 387 (S.D.N.Y. 1971) (disallowed interest); *Marquette Cement Mfg. Co. v. Andreas*, 239 F. Supp. 962, 968 (S.D.N.Y. 1965) (disallowed interest because transaction was innocent); *Perfect Photo, Inc. v. Grabb*, 205 F. Supp. 569, 573 (E.D. Pa. 1962) (allowed interest).

395. *Western Auto Supply Co. v. Gamble-Skogmo, Inc.*, 348 F.2d 736, 744 (8th Cir. 1965), *cert. denied*, 382 U.S. 987 (1966); *Magida v. Continental Can Co.*, 231 F.2d 843, 848 (2d Cir.), *cert. denied*, 351 U.S. 972 (1956).

396. For cases allowing dividends, see *Western Auto Supply Co. v. Gamble-Skogmo, Inc.*, 348 F.2d 736, 743-44 (8th Cir. 1965), *cert. denied*, 382 U.S. 987 (1966); *Marquette Cement Mfg. Co. v. Andreas*, 239 F. Supp. 962, 968 (S.D.N.Y. 1965). For cases denying dividends, see *Blau v. Lamb*, 363 F.2d 507, 528 (2d Cir. 1966), *cert. denied*, 385 U.S. 1002 (1967); *Adler v. Klawans*, 267 F.2d 840, 847 (2d Cir. 1959).

397. *Marquette Cement Mfg. Co. v. Andreas*, 239 F. Supp. 962, 968 (S.D.N.Y. 1965).

398. *Newmark v. RKO Gen., Inc.*, 425 F.2d 348, 357-58 (2d Cir.), *cert. denied*, 400 U.S. 854 (1970). The "control premium" was an estimate of the additional value of the shares to RKO because they gave RKO legal control of Frontier Airlines, Inc.

399. *Gadsby & Treadwell*, *supra* note 302, at 693-94; 37 J. AIR & COMM. L. 457, 463-64 (1971).

“objective” approach in construing the elements “equity security,” “class of security,” “beneficial owner,” “director,” timing of the status of “director” and “officer,” and “six months” in a particular factual situation.

More often than not, the reason given by the courts for the application of either approach is the need to effectuate the broadly remedial purpose of the 1934 Act. Each element is analyzed to determine whether its scope should be expanded or limited in light of this purpose. Arguably, therefore, some of those courts that adopt the objective approach first engage in the same pragmatic determination of whether the particular element should be literally construed, by finding, in effect, that the analysis adopted by the legislature is appropriate. On the other hand, some courts that have adopted the objective approach have followed the analysis of *Heli-Coil Corp. v. Webster*⁴⁰⁰ that Congress has already engaged in a delicate balancing process in drafting section 16(b), and therefore the judicial role should be limited to applying literal terms to particular transactions.

This was the judicial state of affairs concerning section 16(b) before the Supreme Court and the lower federal courts began their most recent analysis in late 1971.

B. Recent Developments

Most decisions by the lower federal courts prior to the decisions of the Supreme Court in *Reliance Electric Co. v. Emerson Electric Co.*⁴⁰¹ and *Kern County Land Co. v. Occidental Petroleum Corp.*⁴⁰² followed the mainstream of the law previously discussed; no new rules, nor new theories for old rules, were announced. Instead, these recent decisions are important for their reinforcement of previous judicial patterns.

1. Miscellaneous

In the area of the definition of statutory insiders, two significant opinions appeared. In *Levy v. Seaton*⁴⁰³ the court was faced with a situation “[w]here *both* the purchase and the sale [occurred] within six months of each other [but] after the officer [had] left the employ of

400. 352 F.2d 156 (3d Cir. 1965).

401. 404 U.S. 418 (1972).

402. 411 U.S. 582 (1973).

403. 358 F. Supp. 1 (S.D.N.Y. 1973).

the corporation."⁴⁰⁴ Seaton was a vice president of General Motors from January 1957 to August 31, 1970. On March 19, 1962, General Motors granted Seaton a stock option for the purchase of common shares at \$56.82 per share. Under the terms of the agreement, the option would expire three months after Seaton left General Motors. On November 24, 1970, Seaton sold 2000 shares of General Motors stock at \$75.50 per share, and three days later acquired 2151 shares through the exercise of the option. The court held that Seaton was not liable for the profits he received, distinguishing *Adler v. Klawans*⁴⁰⁵ and *Feder v. Martin Marietta Corp.*⁴⁰⁶ on the ground that in both of those cases the defendant was a director during at least one of the transactions. The *Levy* court reasoned that "where a person is neither an officer at the time of purchase nor at the time of sale . . . there is no statutory rule that he is conclusively presumed to have acquired 'information . . . by reason of his relationship to the issuer' . . ." ⁴⁰⁷

Levy is significant in two respects. First, the court implicitly recognized a statutory "conclusive presumption" that certain individuals have acquired and used inside information. Secondly, the court stated that this presumption no longer exists if neither transaction occurred while the defendant was an officer, even if he was an officer three months before. The language of the statute does not indicate whether an officer or director need be an insider during both transactions.⁴⁰⁸ For this reason, the court could have adopted a subjective analysis and searched the facts to determine whether a possibility of speculative abuse existed as a result of Seaton's prior position. Instead, the court remained steadfast in its strict, objective application of the statute.

The question whether the owner of less than ten percent of a corpo-

404. *Id.* at 3-4 (emphasis original).

405. 267 F.2d 840 (2d Cir. 1959). See text accompanying notes 338-43 *supra*.

406. 406 F.2d 260 (2d Cir. 1969), *cert. denied*, 396 U.S. 1036 (1970). See text accompanying notes 344-45 *supra*.

407. 358 F. Supp. at 5, quoting 1934 Act § 16(b), 15 U.S.C. § 78p(b) (1970).

408. Except for the exemption clause, the statutory language is unclear as to all insiders. For this reason, the courts in *Adler* and *Feder* relied heavily on the statute's exemption language. Arguably, the use of the word "both" in the exemption implies, with respect to officers and directors, "at least one." But, if, as the introductory language makes clear, the statute was intended to limit the use of inside information acquired by insiders "by reason of their relationship to the issuer," the statute arguably did apply to the transactions in question, since they might have been based on inside information Seaton acquired while still an officer of General Motors. Thus the statute may apply to one who was a director or officer "at some time." *Adler v. Klawans*, 267 F.2d 840, 844 (2d Cir. 1959) (emphasis original).

ration's convertible preferred stock could be considered a ten-percent "beneficial owner" for purposes of the corporation's common stock was answered in the affirmative in *American Standard, Inc. v. Crane Co.*⁴⁰⁹ The court applied the "hypothetical conversion" test,⁴¹⁰ in which the defendant is considered a ten-percent beneficial owner if upon a hypothetical conversion of his preferred stock he would own more than ten percent of the common. The rule is not based on a subjective analysis of whether, by reason of his ownership of the preferred, the defendant had access to inside information. Instead, it is based on the economic reality that the holder of convertible preferred stock easily and swiftly may become an owner of common stock.

A number of recent cases have been concerned with problems of purchases and sales. On the whole, these decisions have reaffirmed the proposition that section 16(b) automatically applies (that is, the courts have no difficulty applying the section) to "ordinary" purchases and sales.⁴¹¹ The difficulties continue to arise in attempting to apply the statute to "unorthodox" transactions.

Two cases considered the problem of corporate reorganization. In *Morales v. Arlen Realty & Development Corp.*⁴¹² defendant Weisman, an officer and director of Spartan Industries, received shares of Arlen Realty pursuant to an exchange agreement which became effective when Spartan merged with Arlen. Weisman also became a director of Arlen. Within six months, Weisman sold some of his newly acquired shares. After finding that Weisman had no control over the planning or ratification of the merger, the *Morales* court held that the acquisition of shares pursuant to the exchange agreement was not a purchase.⁴¹³ Weisman's involvement in the exchange was considered involuntary.⁴¹⁴

The court in *American Standard, Inc. v. Crane Co.*,⁴¹⁵ on the other

409. 346 F. Supp. 1153, 1170 (S.D.N.Y. 1971).

410. See SEC rule 16a-2(b), 17 C.F.R. § 240.16a-2(b) (1974); cf. *Chemical Fund, Inc. v. Xerox Corp.*, 377 F.2d 107, 111 (2d Cir. 1967).

411. See, e.g., *Mouldings, Inc. v. Potter*, 465 F.2d 1101, 1104 (5th Cir. 1972) (to apply subjective test, facts must rise above case of "garden variety" purchase and sale); *Morales v. Arlen Realty & Dev. Corp.*, 352 F. Supp. 941, 944 (S.D.N.Y. 1973) (no reason to apply subjective test when ordinary purchases and sales involved).

412. 352 F. Supp. 941 (S.D.N.Y. 1973).

413. *Id.* at 945. The court specifically stated:

In the absence of a showing that he wielded any control over the terms or timing of the Arlen-Spartans merger, his acquisition of Arlen stock pursuant to the merger did not constitute a "purchase" within the meaning of § 16(b).

414. *Id.*; see text accompanying note 361 *supra*.

415. 346 F. Supp. 1153 (S.D.N.Y. 1971).

hand, considered the element of control over the timing and terms of the merger to be a factor in determining whether the merger gave rise to a possibility of speculative abuse. Beginning in mid-1967 Crane had engaged in a tender offer program to buy Westinghouse Air Brake common stock. By January 26, 1968, Crane owned more than ten percent of Air Brake. In response, Air Brake entered into merger negotiations with American Standard, and on March 7, 1968, they announced to the public that a merger agreement had been reached. The agreement did not hinder Crane's efforts, however, for on April 6th, Crane publicly announced a new tender offer. The tender offer failed, for at the close of the offering period Crane owned only thirty-two percent of Air Brake, and on May 16, 1968, the other stockholders of Air Brake voted to approve the merger. Soon after receiving its shares of American Standard for its Air Brake shares, Crane sold them at a profit.

The *American Standard* court applied a two-part test to the exchange transaction. After first determining that the possibility of speculative abuse existed, the court considered whether the transaction could reasonably be considered a purchase or sale. In deciding that the possibility of speculative abuse existed, the court presumed that ten-percent beneficial owners have inside information.⁴¹⁶ Further, the court found the presumption in this case was supported by the facts: Crane continued its tender offers, knowing that whether it won or lost the proxy fight, it would still benefit; Crane continued its tender offers, knowing that Air Brake was engaged in merger negotiations; and, by its holdings, Crane could influence the terms and timing of the merger.⁴¹⁷

It is significant that the *American Standard* court refused to examine closely the facts surrounding the exchange transaction. Instead, the court emphasized Crane's tenacity in light of the odds against it and the possible influence Crane might wield. The court did not, however, seek to determine whether this tenacity or influence specifically enabled Crane to gain access to inside information. Further, the court ignored the problem that Crane's influence existed while it was an insider of Air Brake, not while it was an insider of American Standard—the status that it held when the sale took place.

416. *Id.* at 1159.

417. *Id.*

Two recent cases have considered whether the receipt of stock pursuant to the exercise of a non-transferable, qualified stock option is a "purchase." Although the courts in *Brenner v. Career Academy, Inc.*⁴¹⁸ and *Keller Industries, Inc. v. Walden*⁴¹⁹ held that the receipt was a "purchase," the significance of the opinions lies in the courts' treatment of the insiders' allegations that the purchases were exempted by rules 16b-9⁴²⁰ and 16b-3,⁴²¹ respectively. In *Brenner* the court refused to exempt the purchase, holding that a stock option is not an acquisition of the type exempted by rule 16b-9.⁴²² In *Keller* the court reemphasized the parenthetical language of rule 16b-3⁴²³ and held that the inducement of preferable tax treatment for holding the option for a certain length of time⁴²⁴ does not alter the specific exception from the exemption under the rule.

Finally, one recent case considered the question of *when* the purchase or sale was deemed to have taken place. In *Champion Home Builders Co. v. Jeffress*,⁴²⁵ Champion acquired Concord Mobile Homes by purchasing all of Concord's stock, then owned by Jeffress, in exchange for thirteen percent of Champion's stock and a directorship for Jeffress. The exchange agreement was entered into by Jeffress and two officers of Champion on February 17, 1968, subject to the ratification of the directors, who approved the contract by resolution on February 21, 1968. The formal agreement was executed on April 17, 1968. Jeffress sold a portion of his holdings on September 17, 1968. The district

418. 467 F.2d 1080 (7th Cir. 1972).

419. 462 F.2d 388 (5th Cir. 1972).

420. 17 C.F.R. § 240.16b-9 (1974).

421. 17 C.F.R. § 240.16b-3 (1974).

422. 467 F.2d at 1083.

This holding seems somewhat strained in light of the statutory definition of "equity security" contained in § 3(a)(11) of the 1934 Act, 15 U.S.C. § 78c(a)(11) (1970). See text quoted note 299 *supra*. The statutory definition includes both "warrants" and "rights." Judicial precedent, however, seems split on the question. See, e.g., *Bershad v. McDonough*, 428 F.2d 693, 698 (7th Cir. 1970), *cert. denied*, 400 U.S. 992 (1971) (suggesting that option is equity security); *Shaw v. Dreyfus*, 172 F.2d 140 (2d Cir.), *cert. denied*, 337 U.S. 907 (1949) (warrant is equity security). See also *Chemical Fund, Inc. v. Xerox Corp.*, 377 F.2d 107 (2d Cir. 1967) (discussion of definition of equity security); *Silverman v. Landa*, 306 F.2d 422 (2d Cir. 1962) (discussion of definition of equity security); *Laufer*, *supra* note 302, at 236.

423. 462 F.2d at 390. The parenthetical language, "other than stock acquired upon the exercise of an option, warrant or right," excepts from the rule's general exemption the receipt of stock pursuant to the exercise of an option.

424. See INT. REV. CODE OF 1954, § 422.

425. 490 F.2d 611 (6th Cir. 1974), *rev'g* 352 F. Supp. 1081 (E.D. Mich. 1973).

court, following the traditional test that the purchase and sale take place when the parties are "irrevocably bound," held that Jeffress did not acquire his Champion shares within six months of the sale. The trial court found that

on February 21 the parties had reached a meeting of the minds on the essentials of their exchange agreement and . . . if matters had thereafter bogged down in the drafting of a formal contract, either party could have sued to enforce the contract or for its breach. Since this was merely a purchase of stock by Champion, all that was needed to bind the corporation to the deal was the approval of the Board of Directors.⁴²⁶

The court added that since Jeffress participated in the directors' meeting at the time the contract was approved, he "became privy to information disclosed at that meeting and the public was led to believe that Jeffress was an 'insider' from that time forward."⁴²⁷ The Sixth Circuit reversed, holding that no "purchase" had occurred with the February 21st resolution. The appellate court found that the resolution had the legal effect of "nothing more than an authorization to negotiate,"⁴²⁸ which did not render Jeffress irrevocably bound to take and pay for the stock or vest in him any incidents of ownership.

The final area that concerned the courts was profits. The six-month provision in rule 16b-6 was construed by one court to mean a full six-month period;⁴²⁹ another court considered the "date of transfer" as the

426. 352 F. Supp. at 1083.

427. *Id.* at 1084. The court further noted that the statute of frauds did not alter this holding since the minutes of the board meeting were a sufficient writing. *Id.* It is interesting to note in this regard that that statute of frauds, if it applies, may significantly affect the result under § 16(b) if the "irrevocably bound" test is applied.

428. 490 F.2d at 617. Both *Jeffress* courts thus agreed that the "irrevocably bound" test, *see* cases cited note 382 *supra*, should be employed. They differed, however, in their view of the commitment to purchase reflected in the resolution of February 21st. The Sixth Circuit emphasized the following contingencies:

Jeffress incurred no irrevocable liability to take and pay for the Champion stock because he had not signed the Board minutes. Moreover, because there had been no consideration or contractual intent, the resolution cannot be viewed as giving him an option to buy Champion stock. Although resolutions such as the one before us are a prerequisite to corporate transactions of the type here involved, they are only a prelude to negotiations and may be rendered ineffective when the negotiations deadlock.

490 F.2d at 617. The court held that the transaction did not present a potential for speculative abuse, since at the time of the resolution, Jeffress was not a statutory insider of Champion, nor did he have advance knowledge of the merger. *Id.*

429. *Morales v. Walt Disney Prods.*, 361 F. Supp. 1157, 1158 (S.D.N.Y. 1973). The court rejected the argument that the six-months-less-one-day period of the statute should apply under the rule. *See* note 356 *supra*.

appropriate date for measuring profits under the rule.⁴³⁰ The most important recent decision in this area, however, was *Mouldings, Inc. v. Potter*.⁴³¹ Potter, an officer and director of Mouldings, sold 8000 shares of Mouldings through his broker. A few days later, the broker discovered that the securities were not registered and thus could not be sold. Therefore, Potter became liable to the broker to replenish the shares. To avoid section 16(b) liability, Potter engaged in a process of novation: a group of business associates acted as sellers by

tak[ing] his place in the transaction *ab initio*. He would return to [the broker] the sum which he had already received from [him]. The [sellers] would take over his obligation to sell and [the broker] would pay them the original sum as sellers.⁴³²

These new shares were received at a lower price. After finding that the novation transaction was a purchase, the court held that Potter "realized" a profit in the transaction, since he had control over the ultimate destination of the profits. The court reasoned that

[o]ne intent of § 16(b) is to cast the officer-director thereunder into a fiduciary capacity for the benefit of all the shareholders of the corporation. We cannot countenance an effort by such a fiduciary to prefer some stockholders over others through control and designation of profits.⁴³³

2. "Subjective" v. "Objective" Approach

The two most important recent cases construing section 16(b) are *Reliance Electric Co. v. Emerson Electric Co.*⁴³⁴ and *Kern County Land Co. v. Occidental Petroleum Corp.*,⁴³⁵ for the Supreme Court chose these two cases as vehicles for entering and resolving a portion of the quagmire created by the decisions of the lower federal courts concerning the scope of the substantive elements of section 16(b).⁴³⁶

430. *Brenner v. Career Academy, Inc.*, 467 F.2d 1080 (7th Cir. 1972).

431. 465 F.2d 1101 (5th Cir. 1972), *cert. denied*, 410 U.S. 929 (1973).

432. *Id.* at 1103.

433. *Id.* at 1105.

434. 404 U.S. 418 (1972).

435. 411 U.S. 582 (1973).

436. Prior to *Reliance* and *Kern County*, the Supreme Court had decided only one other case under § 16(b). In *Blau v. Lehman*, 368 U.S. 403 (1962), the Court followed the concurring opinion of Judge Learned Hand in *Rattner v. Lehman*, 193 F.2d 564, 566 (2d Cir. 1952), in holding that a partnership was liable for the profits it received from short-swing trading in the shares of a corporation, if the partnership had deputed a partner to represent its interests as director of that corporation. *See also*

a. *Reliance Electric*

In *Reliance Electric*, Emerson Electric acquired 13.2% of the outstanding common stock of Dodge Manufacturing pursuant to a tender offer in an unsuccessful attempt to take over Dodge. The attempt was defeated by Dodge's defensive merger agreement with Reliance Electric, which had been authorized by Dodge's shareholders. Within six months of its acquisition, Emerson, pursuant to counsel's recommendation, engaged in two transactions: first, Emerson sold enough of its Dodge shares to reduce its holdings to 9.96%; secondly, two weeks later Emerson sold its remaining shares to Dodge. As a result of both sales, Emerson realized a substantial profit.

Emphasizing the objective nature of the statute, the Supreme Court held that Emerson would be liable only for those profits received as a result of the *first* sale. The Court described in broad terms the method that Congress chose to remedy the speculative abuses caused by insider trading: Congress chose to take the profit out of a "class of transactions in which the possibility of abuse was believed to be intolerably great."⁴³⁷ Thus, since Congress did not mean to reach every transaction in which an insider actually used inside information, the question became whether the transaction, consciously structured to take it outside the literal prohibition of section 16(b), was also outside the intolerable "class of transactions." Citing the language of the statutory exemption⁴³⁸ and reading its terms literally, the Court concluded that Emerson's second sale was a transaction that Congress did not intend to cover.

The *Reliance Electric* Court's short discussion of the congressional intention to cover a "class of transactions" seems to have been more than a mere introductory discussion of section 16(b). The Court, in-

Feder v. Martin Marietta Corp., 406 F.2d 260 (2d Cir. 1969), cert. denied, 396 U.S. 1036 (1970); Marquette Cement Mfg. Co. v. Andreas, 239 F. Supp. 962 (S.D.N.Y. 1965).

437. 404 U.S. at 422. The Court's use of the term "class of transactions" did not refer to the nature of the transaction, *i.e.*, whether it was a cash sale or a merger. Instead, the Court indicated that it was referring to a transaction defined in the terms of the statute's substantive elements.

438. "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 . . ." 1934 Act § 16(b), 15 U.S.C. § 78p(b) (1970).

stead, emphasized that only those *transactions* defined by section 16(b) were considered by Congress to fall within that "class of transactions in which the possibility of abuse was believed to be intolerably great."⁴³⁹ In other words, liability was not defined in terms of an individual's status in the corporation; instead, it was defined in terms of a "class of transactions" in which the status of the individual was merely an element. Thus, in order for any statutory presumption to arise, all of the elements of the forbidden transaction must exist.

In *Reliance Electric* all the elements of the forbidden transaction were present in the first sale, but the ten-percent beneficial-ownership requirement was absent in the second sale. Justice Douglas, dissenting, asserted that the absence of this element was cured by the statutory presumption that ownership of ten percent of the stock "suffices to provide access to inside information."⁴⁴⁰ The majority, rejecting Justice Douglas's position, stated that the statutory exemption clearly ruled out this position as a basis for liability.

To reject the dissent's position so easily, however, the majority had to read the language of the exemption literally. The reason for this literal reading was that the requirement created by the exemption was "among the 'objective standards' contained in § 16(b)."⁴⁴¹ No explicit reason was given why this requirement should be read objectively, since the Court did recognize that certain factors may be defined subjectively. Instead, the Court suggested that a subjective construction of this requirement was impossible without predicating liability upon considerations of intent, motive, or improper conduct that are irrelevant to section 16(b).⁴⁴²

This analysis suggests that the Court in *Reliance Electric* sanctioned the use of the subjective approach in defining certain statutory ele-

439. 404 U.S. at 422.

440. *Id.* at 442.

441. *Id.* at 423.

442. In a footnote, the Court recognized that the terms "purchase," "sale," "officer," and "director" may be subjectively defined. But the Court's insistence upon an objective construction was emphasized by the language of the closing two sentences of the footnote. The Court stated:

The various tests employed in these cases [that applied the subjective approach] are used to determine whether a transaction, objectively defined, falls within or without the terms of the statute. In no case is liability predicated upon "considerations of intent, lack of motive, or improper conduct" that are irrelevant in § 16(b) suits. *Blau v. Oppenheim*, 250 F. Supp. 881, 887 [(S.D.N.Y. 1966)].

404 U.S. at 424 n.4.

ments, as long as the application of this approach does not require proof of those factors the statute deems irrelevant. The analysis also suggests that the holding of *Stella v. Graham-Paige Motors Corp.*⁴⁴³ may be in jeopardy.⁴⁴⁴

b. *Kern County*

The Court's implicit approval of the use of the subjective approach for defining the terms "purchase" and "sale" in *Reliance Electric* was transformed into explicit approval by the majority in *Kern County Land Co. v. Occidental Petroleum Corp.*⁴⁴⁵ Rejecting the objective approach, the majority instead inquired whether the "unorthodox" transaction served as a vehicle for the realization of short-swing profits based upon access to inside information.⁴⁴⁶ After engaging in a detailed factual analysis, the majority held that because there was an absence of any possibility of speculative abuse, the transaction was not a "sale."

After unsuccessfully seeking to merge with Kern County Land Company (Old Kern), Occidental Petroleum announced a tender offer for 500,000 shares of Old Kern common stock. As a result of the success of this first tender offer,⁴⁴⁷ Occidental extended its offer to encompass an additional 500,000 shares. By June 8, 1967, Occidental owned 887,549 shares of Old Kern. The Old Kern management attempted to frustrate Occidental's takeover bid by advising its shareholders against tendering and by engaging in merger discussions with Tenneco, Inc. On May 19, 1967, the board of directors of Old Kern announced its approval of the Tenneco merger proposal. Under the proposal, Kern County Land Company (New Kern) was to be formed to receive the assets and carry on the business of Old Kern.

Occidental realized that if the defensive merger were approved it would be locked into a minority position in Tenneco, and therefore it

443. 104 F. Supp. 957 (S.D.N.Y. 1952). See notes 330-34 *supra* and accompanying text.

444. See, e.g., Turner, *Securities Law—"Split Sale" § 16(b) Liability of Beneficial Owners for Short-Swing Profits*—*Reliance Electric Company v. Emerson Electric Company*, 92 S. Ct. 596 (1972), 49 DENVER L.J. 69 (1972); Comment, *Split Sale Schemes Under Section 16(b): Additional Justification for the Supreme Court Majority's Approach in Reliance Electric Co. v. Emerson Electric Co.*, 45 TEMPLE L.Q. 501 (1972); 25 U. FLA. L. REV. 412 (1973); 39 BROOKLYN L. REV. 206 (1972).

445. 411 U.S. 582 (1973). See note 442 *supra* and accompanying text.

446. *Id.* at 594.

447. At the close of the first tender offer, Occidental owned over 10% of Old Kern. *Id.* at 585.

took steps to protect itself. Primarily, it negotiated an arrangement with Tenneco by which Occidental gave a subsidiary of Tenneco an option to purchase all of Tenneco's preferred stock to which Occidental would be entitled pursuant to the merger exchange. By the terms of the option agreement, the option could not be exercised until six months and one day after the expiration of Occidental's tender offer. On June 2, 1967, Occidental and Tenneco exercised the option. The merger plan was presented to and approved by Old Kern stockholders on July 17, 1967. Occidental did not vote its shares, but stated that it did not oppose the merger. The merger transaction was closed on August 30th, and Occidental received its preferred shares of Tenneco pursuant to the exchange on December 11, 1967, six months and three days after the close of Occidental's tender offer. Tenneco's subsidiary then exercised the option.

After reiterating the belief expressed in *Reliance Electric* that Congress, in enacting section 16(b), meant to regulate a particular "class of transactions,"⁴⁴⁸ the *Kern County* majority adopted the "subjective" approach to determine whether an unorthodox transaction is a "purchase" or "sale."⁴⁴⁹ The reason for the adoption of the subjective approach was the fear that the broad definitions of "purchase" and "sale" may "at least arguably, reach many transactions not ordinarily deemed a sale or purchase."⁴⁵⁰ The element missing from such "unorthodox transactions" is volition.⁴⁵¹ Arguably, therefore, the majority's reason for adopting the subjective approach was the fear that if the statute were literally applied, certain insider's activities would be covered by the statute even though the exchange of value was involuntary. Such an approach was considered too harsh in light of the congressional policies behind section 16(b).⁴⁵²

Since the terms "purchase" and "sale" were construed in view of the policies behind section 16(b), the element of volition also had

448. *Id.* at 592, citing *Reliance Elec. Co. v. Emerson Elec. Co.*, 404 U.S. 418, 422 (1972).

449. 411 U.S. at 594. The use of the subjective approach to define a "purchase" or "sale" is appropriate under the majority's narrowly stated test, for by its use liability will not be predicated on considerations of intent, motive, or improper conduct.

450. *Id.*

451. See note 366 *supra*. But see 411 U.S. at 607 (Douglas, J., dissenting).

452. This approach of defining the terms "purchase" and "sale" in light of the policies of § 16(b) is supported by the preamble to 1934 Act § 3(a), 15 U.S.C. § 78c(a) (1970), which permits the terms defined therein to be construed differently if "the context otherwise requires."

to be defined in light of those policies. Thus, volition was considered present whenever "the particular type of transaction involved is one that gives rise to speculative abuse."⁴⁵³

Although the subjective test was broadly stated in *Kern County*, it was not so broadly applied, for instead of looking to broadly defined "types of transactions,"⁴⁵⁴ as Justice Douglas suggested in his dissent,⁴⁵⁵ the majority closely scrutinized Occidental's position and the facts leading up to the point when the company was "irrevocably entitled to exchange its shares of Old Kern stock for shares of Tenneco preferred stock."⁴⁵⁶ The majority emphasized that at each stage in the activities Occidental had no control over future events⁴⁵⁷ and that the type of information it possessed was available to the general public, and, consequently, was not *inside* information. Further, Old Kern's efforts to deter Occidental's takeover bid placed Occidental in the position of an outsider insofar as the availability of inside information was concerned. Therefore, the majority concluded, "the involuntary nature of Occidental's exchange, when coupled with the absence of the possibility of speculative abuse of inside information,"⁴⁵⁸ kept the transaction from falling within the ambit of section 16(b).

453. 411 U.S. at 595, quoting *Reliance Elec. Co. v. Emerson Elec. Co.*, 404 U.S. 418, 424 n.4 (1972). In this context, the Court was using the term "transaction" in its narrow sense, that is, not as a "class of transactions" in which all the elements of § 16(b) are present, but as an activity in which value is exchanged.

454. 411 U.S. at 609. Under a broad-definition approach, all mergers may be considered the type of transaction which gives rise to speculative abuse, while defensive mergers may not.

455. 411 U.S. at 609 (Douglas, J., dissenting).

456. 411 U.S. at 596. Considering the date of the alleged sale as the date when Occidental became irrevocably bound was consistent with prior case law. See note 382 *supra* and accompanying text.

457. The majority, citing cases dealing with coercion due to economic feasibility, also rejected the claim that since Occidental could have sold its shares for cash, a transaction which would be considered a sale, the actual exchange should be considered a sale. 411 U.S. at 600. The cases cited, however, do not support this conclusion, for they deal with pure economic coercion, and not economic coercion coupled with a legal liability, as in *Kern County*.

458. 411 U.S. at 600. That the majority separated the requirement of volition from that of the possibility of speculative abuse does not detract from their interrelatedness. Although a transaction may be involuntary in that the person has no control over the course of certain future events, the fact that the person may have certain inside information may make the transaction voluntary in that the person may wish to react to those events in a particular manner. For example, if Occidental had inside information concerning the exchange rate between Old Kern and Tenneco, it may have wished to buy in further, not with the intention of completing its takeover, but with the knowledge that the exchange rate would make it economically beneficial.

Similar reasoning led the majority to conclude that the option agreement itself was not a "sale." First, since there were mutual advantages to be gained from the arrangement, Occidental's *motivations* did not "smack" of insider trading.⁴⁵⁹ Furthermore, because the call price was fixed in the option, even if Occidental possessed inside information, it could not have taken advantage of it. It was not a case of "heads I win, tails I don't lose."⁴⁶⁰

c. *Gold v. Sloan*

The most significant case to apply *Kern County's* subjective test has been *Gold v. Sloan*.⁴⁶¹ In *Gold*, four insiders⁴⁶² of Atlantic Research Corporation (ARC) received shares of Susquehanna Corporation when ARC merged into Susquehanna. In addition, the four defendants became insiders of Susquehanna.⁴⁶³ Within six months of the receipt of these shares, the insiders sold a number of shares at a profit. The sole issue was whether the exchange of shares pursuant to the merger constituted a "purchase" within the terms of the statute.

The *Gold* majority, after discussing the *Kern County* decision, found defendant Sloan liable and dismissed the actions against the others. In essence, the court found that the possibility of speculative abuse was available only to Sloan. To reach this conclusion, the court discussed in detail the positions and roles of the four defendants in the merger negotiations, and found that only one was in a position not only to receive inside information but also to control the negotiations.⁴⁶⁴ Further,

459. 411 U.S. at 601. It is interesting to note that the majority spoke freely of motivation, while the Court in *Reliance Electric* considered motivation irrelevant.

460. See *Newmark v. RKO Gen., Inc.*, 425 F.2d 348 (2d Cir.), cert. denied, 400 U.S. 854 (1970).

461. 486 F.2d 340 (4th Cir. 1973), petition for rehearing en banc denied, 491 F.2d 729 (4th Cir. 1974) (Haynsworth, C.J., dissenting).

462. Prior to November 1962, defendant Sloan was the president and chief executive officer of ARC. In November he was removed from the office of president and made chairman of the board. Defendant Rumbel was an officer in ARC. Defendant Scurlock was the chief executive officer and a director of ARC. Defendant Sloane was a vice president of ARC.

463. After the merger Scurlock became a director of Susquehanna, Sloan became chief executive officer of Susquehanna, Rumbel became senior vice president of a division of Susquehanna, and Sloane became a vice president of the same division.

464. Thus the interconnected elements of possibility of speculative abuse and volition were present. The inquiry into access to inside information and control was appropriate since these two elements were relied upon by the *Kern County* majority. See *Kern County Land Co. v. Occidental Petroleum Corp.*, 411 U.S. 582, 599-600. See

not only was Sloan in a position to engage in these activities, he also did receive inside information.⁴⁶⁵

The Fourth Circuit's decision in *Gold* takes *Kern County* to its logical conclusion. First, under the subjective approach a transaction may now be a "purchase" with respect to one insider, but not a "purchase" with respect to another. This seems ludicrous when one transaction is involved. Secondly, the primary reason for this seemingly anomalous result is the *Gold* court's extremely detailed analysis of the insiders' roles in the transaction. The mere position of the insider (that is, as director or president) was not enough; he also had to be in a position where he could have received inside information.

The *Gold* court's detailed analysis is a cause for much concern. If the basis of the subjective test is whether there has been a *possibility* of speculative abuse, why was it necessary to determine whether the insider possessed inside information? An insider may now regulate his activities to avoid leaving any evidence of his possession of inside information and thus avoid liability under a statute that was originally intended to be a "crude rule of thumb"⁴⁶⁶ predicating liability on objective criteria. Further, although an insider may have no power to alter the outcome of the merger negotiations, why should this lack of choice affect the determination of whether the particular transaction was a "purchase"? The majority's fear in *Kern County* that an insider may be liable under section 16(b) by the mere fact of his involuntary receipt of stock does not exist when an initial transaction is involved, for the defendants in *Gold* still could have chosen whether to sell the stock within six months after the merger.

This latter consideration was a cause of concern to Judge Winter, who dissented in *Gold*. Judge Winter disagreed with the majority's refusal to consider whether the insiders had access to inside information after the merger was completed.⁴⁶⁷ He stated that the majority could

also Dietz, *A Practical Look at Section 16(b) of the Securities Exchange Act*, 43 FORDHAM L. REV. 1, 25 (1974); Lang & Katz, *Section 16(b) and "Extraordinary" Transactions: Corporate Reorganizations and Stock Options*, 49 NOTRE DAME LAW. 705, 712 (1974).

465. 486 F.2d at 352.

466. Justice Douglas expressed this fear in his dissent in *Kern County*. See *Kern County Land Co. v. Occidental Petroleum Corp.*, 411 U.S. 582, 608-09. Note, too, that the preamble to § 16(b) states that the purpose of the statute is to prevent "the unfair use of inside information which may have been obtained" by an insider. 15 U.S.C. § 78p(b) (1970) (emphasis added).

467. 486 F.2d at 354-56.

not rely on *Kern County* for this proposition, since that case dealt with a closing transaction, while the *Gold* court was faced with an opening transaction. Further, prior to the merger the defendants were not insiders of the corporation to which they would be liable.

Thus, it is at least questionable whether the subjective approach can be applied to an opening transaction. As an administration spokesman pointed out before a Senate committee in 1934,

You hold the director, irrespective of any intention or expectation to sell the security within six months after, because it will be absolutely impossible to prove the existence of such intention or expectation, and you have to have this crude rule of thumb, because you cannot undertake the burden of having to prove that the director intended, at the time he bought, to get out on a short swing.⁴⁶⁸

Access to information at the time of the opening transaction, therefore, is irrelevant, at least to the extent that the information does not consist of data indicating that the stock could be sold at a profit within the next six months.⁴⁶⁹ Whether the insider has access to inside information concerning merely the practicability of consummating the opening transaction is irrelevant, since the benefits received from that transaction alone are not recoverable under the Act. On the other hand, access to the same information concerning the closing transaction is relevant, since the profit received through that transaction is the very profit which the statute sought to discourage.

In light of the difficulties inherent in *Kern County* and its progeny, *Gold*, the fears expressed by Justice Douglas in his dissent in *Kern County* are easy to understand.

Instead of a section that is easy to administer and by its clearcut terms discourages litigation, we have instead a section that fosters litigation because the Court's decision holds out the hope for the insider that he may void § 16(b) liability.⁴⁷⁰

Further, if the majority's language in *Gold*⁴⁷¹ is taken literally, and the plaintiff is required to prove actual possession of inside information, section 16(b) begins to look very much like section 10(b) of the 1934 Act,⁴⁷² for under that section the petitioner must prove that a

468. *Hearings, supra* note 289, at 6557 (statement of Thomas Corcoran).

469. *See generally* 72 MICH. L. REV. 592 (1974).

470. 411 U.S. at 612 (Douglas, J., dissenting).

471. 486 F.2d at 352.

472. 15 U.S.C. § 78j(b) (1970). *See Gadsby & Treadway, supra* note 302, at 714-15; Comment, *supra* note 444, at 516; Note, *supra* note 283, at 158-59 (all suggesting that rule 10b-5 may be employed in borderline cases).

person knew a material fact that he misrepresented or failed to disclose prior to a purchase or sale.⁴⁷³

C. Conclusion

It is not difficult to perceive why the subjective approach is applied. Attaching liability to a certain "class of transactions" may not only be harsh but also contrary to the legislative purpose of curbing speculative abuse of inside information. Section 16(b) can remain a "crude rule of thumb" for those "transactions" to which it obviously applies. For borderline "transactions," the "context"⁴⁷⁴ may require a definition other than those provided in section 3(a) of the 1934 Act. Moreover, the subjective test, while seemingly contrary to the objective nature of the statute, is not unreasonable. If it is assumed that section 16(b) should not apply in certain borderline situations, the subjective test is the most appropriate test for fulfilling the purpose of the section.

More important, unless the section is amended, the subjective approach, with all its ramifications, is apparently here to stay. The most important concern for potential litigants, therefore, is to determine under what circumstances they will be subjected to liability. Obviously, if a person is an insider, at the time of both the opening and closing transactions, who voluntarily exchanges value for securities and within six months voluntarily exchanges his securities for value at a profit, he will be liable under section 16(b). Liability, however, becomes less predictable when the person is an officer who engages in an "unorthodox transaction" that could be subjectively characterized as a "purchase" and "sale." If the statute were rewritten to incorporate judicial interpretations, it might read as follows:⁴⁷⁵

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

473. Obviously, § 10(b) is somewhat different from § 16(b) in that under § 16(b) an insider would still be liable even if he did disclose the information. Other requirements under § 16(b) also do not apply to § 10(b), such as the insider requirement and the six-month requirement.

474. 1934 Act § 3(a), 15 U.S.C. § 78c(a) (1970) (preamble).

475. The ellipses in the hypothetical indicate sections omitted from the present statute to conform to judicial constructions; additions are printed in italics. The statute as presently in force is set out in note 295 *supra*.

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 transaction⁴⁷⁶ 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 such⁴⁷⁷ at the time of the *closing purchase or sale* of the security involved, or any transaction where such officer or director was not such at either the time of the purchase or the sale, or any transaction or transactions which the Commission by rules and regulations may exempt as not comprehended within the purpose of this subsection.

(1) *For purposes of this subsection only, the term "director" means any director of a corporation, or any person performing a similar function, or, in a borderline case, any person similarly situated who has access to inside information.*

(2) *For purposes of this subsection only, the term "officer" means any officer of a corporation, or any person performing a similar function, or, in a borderline case, any person similarly situated who has access to inside information.*

(3) *For purposes of this subsection only, the term "purchase" means any receipt of a security for value that is voluntary or subject to the possibility of speculative abuse of inside information.*

(4) *For purposes of this subsection only, the term "sale" means any*

476. Section 16(b) presently includes a phrase which explains that the intention the section mandates is irrelevant. The section imposes liability

. . . irrespective of any intention . . . of holding the security purchased or of not repurchasing the security sold for a period exceeding six months.

1934 Act § 16(b), 15 U.S.C. § 78p(b) (1970). Reference to the nature of the intention has been deleted since the courts have construed the present statutory language very broadly. See, e.g., *Reliance Elec. Co. v. Emerson Elec. Co.*, 404 U.S. 418, 424 n.4 (1972). See also note 469 *supra* and accompanying text.

477. The deleted language is: "was not such *both* at the time of the purchase and sale, or the sale and purchase." 1934 Act § 16(b), 15 U.S.C. § 78p(b) (1970) (emphasis added). The Supreme Court's decision in *Foremost-McKesson* may determine whether the deleted language should be returned to the statute, *Provident Sec. Inv. Co. v. Foremost-McKesson, Inc.*, 506 F.2d 601 (9th Cir. 1974), cert. granted, 95 S. Ct. 1117 (1975).

exchange of a security for value that is voluntary or subject to the possibility of speculative abuse of inside information.

(5) For purposes of this subsection only, the term "profit" means the excess of the highest sales price over the lowest purchase price on the day each transaction accrues, and, in the discretion of the court, interest and dividends.