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# Iii. Section 16 (B)

agement with a weapon to defeat tender offers.[84] A practical appraisal of the situation presented to the court is necessary for effective decision-making with regard to tender offers. The standards employed by the courts should be made more uniform; however, the results which flow from the facts presented are of primary importance. The courts thus far have reached compatible results and perhaps this pattern will continue. With subsequent litigation in this area, the standards for relief as well as the results will become homogeneous, to the ultimate benefit of target company shareholders.

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## III. SECTION 16 (b)

Section 16(b)[1] of the Securities Exchange Act of 1934[2] was enacted to prevent corporate officers and directors and beneficial owners of more than ten percent of a corporation's equity securities from profitably misusing inside information in short swing transactions.[3] It provides for recovery by the corporation of insider profits realized on a purchase-sale transaction, or sale-purchase transaction, of the corporation's securities when both ends of the transaction occur within six months.[4] Although presumptions that an insider has access to inside

[84] H.R. REP. No. 1711, 90th Cong., 2d Sess. 4 (1968), *reprinted at* 1968 U.S. CODE CONG. & AD. NEWS 2813.

[1] 15 U.S.C. § 78p(b) (1970).

[2] 15 U.S.C.A. §§ 78a-78kk (Supp. Aug. 1975), *amending* 15 U.S.C. §§ 78a-78hh (1970).

[3] Prior to the enactment of the 1934 Act, insider trading, through participation in stock pools, was widespread. The large profits which insiders were able to realize because of their access to inside information were considered part of the normal compensation for their offices. Section 16 was enacted to prevent such inside trading by requiring statutory insiders to report their holdings in their corporation's securities, 15 U.S.C. § 78p(a) (1970), by providing for recovery of any profits received by an insider in a short swing transaction, *id.* § 78p(b), and by absolutely prohibiting certain insider transactions, *id.* § 78p(c). *See* S. REP. No. 1455, 73d Cong. 2d Sess. 55-68 (1934); Cook & Feldman, *Insider Trading Under the Securities Exchange Act*, 66 HARV. L. REV. 385, 386-87, 408-10 (1953); Hecker, *Section 16(b) of the Securities Exchange Act: An Analysis of the Time When Insider Status is Required*, 24 KAN. L. REV. 255, 260-69 (1976) [hereinafter cited as Hecker].

[4] Section 16(b) provides that the corporation, or one of its shareholders, may sue any statutory insider, officer, director, or beneficial owner of more than ten percent of a class of the corporation's equity securities, for any profits realized on any pair of

information[5] and that he has misused this information if he conducts a profitable short swing transaction[6] seem to indicate the corporation should recover short swing profits in all instances of insider trading,[7] the section's application is not always automatic.[8] Before applying § 16(b), the courts must determine which transactions include both a § 16(b) purchase and sale and whether the presumptions of access to inside information and concurrent misuse are conclusive in all cases. If § 16(b) does apply to a transaction, the courts must then determine the amount of profits recoverable by the wronged corporation and the manner by which the insider is to pay them.

### *A. Initial Purchase Creating Ten Percent Ownership*

Although a director or officer need not have been an insider at both the time of purchase and the time of sale,[9] the exemptive provision of § 16(b) requires that a ten percent beneficial owner be so at both the time of purchase and sale to be liable for profits real-

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purchasing and selling transactions in the corporation's securities within a six month period. Shares acquired in connection with a previously contracted debt are exempt from the section. The section does require, however, that the ten percent owner be such at both the purchasing and selling transactions. No similar requirement applies to an officer or director. Note that § 16(b) purchasing and selling transactions may be in any order. 15 U.S.C. § 78p(b) (1970).

[5] Provident Sec. Co. v. Foremost-McKesson, Inc., 506 F.2d 601 (9th Cir. 1974), *aff'd* 96 S. Ct. 508 (1976); 2 L. Loss, SECURITIES REGULATIONS 1040-42 (2d Ed. 1961). [Hereinafter cited as Loss].

[6] Provident Sec. Co. v. Foremost-McKesson, Inc., 506 F.2d 601 (9th Cir. 1974); 2 Loss, *supra* note 5, 1040-42.

[7] Until recently, § 16(b) was applied automatically, and those insiders who conducted a profitable short swing transaction were held strictly liable for these profits. Reliance Elec. Co. v. Emerson Elec. Co., 404 U.S. 418, 422-23 (1972); 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). The rationale for such an objective application of § 16(b) was that it would be impossible to prove an insider's intent in entering into a transaction or his abuse of information. *See Hearings on S. Res. 84, S. Res. 56, and S. Res. 97 Before the Senate Comm. on Banking & Currency*, 73d Cong., 2d Sess., pt. 15, at 6557 (1934). *See generally* 2 Loss, *supra* note 5, at 1040-44.

[8] The Supreme Court has approved a subjective, or pragmatic, approach in applying § 16(b) if the challenged transaction is unorthodox. *See* Kern County Land Co. v. Occidental Petroleum Corp., 411 U.S. 582 (1973) and text accompanying notes 46-68 *infra*.

[9] Kramer v. Ayer, CCH FED. SEC. L. REP. ¶ 95,483 at 99,439 n.6 and 99,441 (S.D.N.Y. 1976); Feder v. Martin Marietta Corp., 406 F.2d 260 (2d Cir. 1969), *cert. denied*, 396 U.S. 1036 (1970); Adler v. Klawans, 267 F.2d 840 (2d Cir. 1959); Marquette Cement Mfg. Co. v. Andreas, 239 F. Supp. 962 (S.D.N.Y. 1965).

ized in a short swing transaction.[10] However, interpretation of the exemptive provision's language "at the time of" has presented problems.[11] In construing this language, the courts originally adopted a

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[10] This provision provides:

> 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 sale and purchase, of the security involved . . . .

15 U.S.C. § 78p(b) (1970).

[11] *See* Hecker, *supra* note 3; Comment, *Section 16(b) Liability and the Requirement That a 10 Percent Holder Be Such Both at the Time of Purchase and Time of Sale*, 27 ALA. L. REV. 211 (1975); Note, *Ten Percent Stock Ownership—Prerequisite to Section 16(b) Short-Swing Liability*, 16 B.C. IND. & COM. L. REV. 838 (1975); Note, *Involuntariness and Other Contemporary Problems Under Section 16(b) of the Securities and Exchange Act of 1934*, 27 HAST. L.J. 679, 694-703 (1976) [hereinafter cited as Note, 27 HAST. L. J. 679]; Comment, *Is the Purchase By Which One Becomes a Ten Percent Beneficial Owner a Statutory Purchase Within the Meaning of Section 16(b)-?*, 7 RUT.-CAMDEN L. J. 104 (1975) [hereinafter cited as Comment, 7 RUT.-CAMDEN L. J. 104 (1975)]; Note; *Section 16(b)—Ten Percent Beneficial Ownership Must Exist Prior to Both a Purchase and Sale for Liability to Attach*, 53 TEXAS L. REV. 857 (1975).

Another problem with which the courts have dealt in § 16(b) litigation is that of determining when one spouse is the beneficial owner of the other's securities. In Whiting v. Dow Chemical Co., CCH FED. SEC. L. REP. ¶ 95,294 (2d Cir. 1975), the Second Circuit was presented with the issue whether the purchase of a corporation's securities by a director could be matched with the sale of the corporation's securities by the director's spouse. In deciding the issue, the court noted that the director received benefits from his spouse's stock holdings substantially equivalent to ownership, *id.* at 98,504 (spouse's dividend income paid the children's education, family's medical expenses, property taxes, and maintenance expenses of a vacation home), and that the spouse's stock transactions together with his own were part of a common, joint investment plan. *Id.* Thus, the court concluded that the director was the beneficial owner of his spouse's securities and matched the director's purchase with his spouse's sale. *See* SEC Securities Exchange Act Release No. 7793 (Jan. 19, 1966); Shreve, *Beneficial Ownership of Securities Held by Family Members*, 22 BUS. LAW. 431 (1967). The lower court's opinion is discussed in *1974 Security Law Developments*, 32 WASH. & LEE L. REV. 721, 801-02 (1975).

Another recent case, Altamil Corp. v. Pryor, CCH FED. SEC. L. REP. ¶ 95,487 (S.D. Ind. 1975), considered the related issue whether a director would be liable under § 16(b) for short swing transactions in his corporation's securities by his wife. In holding the director liable, the court noted "that the defendant exercised complete control over the purchase and sale of . . . stock . . . in the name of [his wife]." *Id.* at 99,456. Additionally, the defendant benefitted from his wife's stock transactions to the extent that profits realized by his wife would reduce the need for him to transfer assets to the wife's estate. *Id.* at 99,457. The facts of this case are within the purview of a statement in *Whiting*, which provides:

> [c]ases where the husband simply buys stock and puts the shares in his wife's name are relatively simple; so too, . . . where he has sole control of her account.

*Id.* at 98,506. Together, *Whiting* and *Pryor* indicate that beneficial ownership of one

"simultaneous with" construction, thus holding that a purchase which created ten percent beneficial ownership was a § 16(b) purchase.[12] More recently, however, the courts have espoused a "prior to" construction, which requires that insider status exist before a purchase if that purchase is to be deemed part of a § 16(b) transaction.[13]

The difference between these two interpretations lies in the type of abuse by ten percent owners which § 16(b) was intended to prohibit. A short swing transaction may be based on double transaction abuse or single transaction abuse.[14] Double transaction abuse exists when both the purchasing transaction and selling transaction are based on inside information.[15] Thus, to constitute double transaction abuse, insider status must exist prior to the initial transaction. Single transaction abuse exists when only the closing transaction is based on inside information obtained subsequent to the initial transaction.[16] The first case to interpret the section's exemptive provision, *Stella v. Graham-Paige Motors Corp.*,[17] ruled that single transaction abuse was sufficient to hold a ten percent beneficial owner liable under § 16(b). Thus, the purchase which gave the owner more than ten percent of the corporation's shares could be matched with a sale of these shares less than six months later to give rise to § 16(b) liability.[18] Though the court recognized that this initial purchase could not have been motivated by an intent to speculate on the basis of inside information, it concluded that this "simultaneous with" construction of the exemptive provision was necessary to prevent speculative abuse

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spouse's securities by the other will result when one receives benefits from the other's holdings substantially equivalent to ownership or when one substantially controls the other's transactions.

[12] Stella v. Graham-Paige Motors Corp., 104 F. Supp. 957 (S.D.N.Y. 1952), *remanded*, 232 F.2d 299 (2d Cir.), *cert. denied*, 352 U.S. 831 (1956). This decision was followed by a majority of courts until recently. *See, e.g.*, Emerson Elec. Co. v. Reliance Elec. Co., 434 F.2d 918 (8th Cir. 1970), *aff'd on other grounds*, 404 U.S. 418 (1972), Newmark v. RKO General, Inc., 425 F.2d 348 (2d Cir.), *cert. denied*, 400 U.S. 854 (1970).

[13] Allis-Chalmers Mfg. Co. v. Gulf & Western Industries, Inc., 527 F.2d 335 (7th Cir. 1975), *cert. denied*, 96 S. Ct. 865 (1976); Provident Sec. Co. v. Foremost-McKesson, Inc., 506 F.2d 601 (9th Cir. 1974). Until these two holdings, the only case ruling against *Stella* was Arkansas Louisiana Gas Co. v. W. R. Stephens Investment Co., 141 F. Supp. 841, 847 (W. D. Ark. 1956). *See also* Stella v. Graham-Paige Motors Corp., 232 F.2d 299, 302 (Hincks, J., dissenting).

[14] *See* Hecker, *supra* note 3, at 259-60; Note, 27 HAST. L. J. 679, *supra* note 11, at 696-97.

[15] Hecker, *supra* note 3, at 259.

[16] *Id.*

[17] 104 F. Supp. 957 (S.D.N.Y. 1952).

[18] 232 F.2d 299 (2d Cir. 1956).

of inside information at the time of the sale.[19] The court rejected the "prior to" construction because such an interpretation would immunize from § 16(b) sale-repurchase sequences subsequent to the original purchase.[20] In *Provident Securities Co. v. Foremost-McKessen, Inc.*[21] and in *Allis-Chalmers Manufacturing Co. v. Gulf & Western Industries, Inc.*,[22] the Ninth and Seventh Circuits refused to follow the *Stella* interpretation of § 16(b)'s exemptive provision. Rather, these circuits adopted a "prior to" construction based on the conclusion that the section was intended to prevent a ten percent owner from speculating on the basis of double transaction abuse only. Recently, the Supreme Court adopted this interpretation when it affirmed the *Provident* decision.[23]

In *Foremost-McKesson, Inc. v. Provident Securities Co.*, the Supreme Court relied on the legislative history and the exemptive provision of § 16(b) in ruling that a ten percent owner's short swing purchase and sale is subject to § 16(b) liability only if he was a beneficial owner of the securities before the purchase.[24] The Court noted that the original version of the section[25] contemplated insider

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[19] *Id.* at 959-60.

[20] *Id.* at 959. Thus, although the court's holding prevents single transaction abuse, its major concern was how to prevent double transaction abuse in a subsequent sale-repurchase sequence. *See* Hecker, *supra* note 3, at 270.

[21] 506 F.2d 601 (9th Cir. 1974). In *Provident*, Provident Securities Co., wishing to liquidate, agreed to sell its assets to Foremost-McKesson in exchange for Foremost debentures and cash. Since these debentures were immediately convertible into more than ten percent of Foremost common stock, Provident became a ten percent owner and § 16(b) insider of Foremost at the time of this transaction. Six days later, Provident agreed to sell half these debentures to an underwriter at a profit.

[22] 527 F.2d 335 (7th Cir. 1975). In *Allis-Chalmers*, Gulf & Western purchased more than ten percent of Allis-Chalmers' stock. A month later it made a second purchase of Allis-Chalmers' stock. Two months subsequent, Gulf & Western agreed to sell all its Allis-Chalmers stock at a profit. The court held that only the second, not the initial, purchase was a § 16(b) transaction. *Id.* at 338-40.

[23] 96 S. Ct. 508 (1976).

[24] *Id.* at 516-22.

[25] The original version of the 1934 Act was S. 2693, 73d Cong., 2d Sess. (1934). Section 15(b)(1) of that Act provided:

> It shall be unlawful for any director, officer, or owner of securities, owning as of record and/or beneficially more than 5 per centum of any class of stock of any issuer, any security of which is registered on a national securities exchange—
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> (1) To purchase any such registered security with the intention or expectation of selling the same security within six months; and any profit made by such person on any transaction in such a registered security extending over a period of less than six months shall inure to and be recoverable by the issuer, irrespective of any intention or ex-

status prior to a purchase-sale transaction. Its purpose was to prevent insiders, with their inside information, from getting in and out of stock within six months.[26] This original section, which did not distinguish between directors and officers and beneficial owners, was changed to impose liability in both purchase-sale and sale-purchase sequences without requiring insider status prior to the initial transaction.[27] However, the exemptive provision was added and distinguished beneficial owners from other insiders.[28] The Court reasoned that the purpose of the exemptive provison was to preserve the requirement of insider status before the initial transaction when dealing with ten percent owners.[29] Thus, the Court concluded that a "prior to" interpretation of the exemptive provision was necessary to implement Congress' intent.[30]

The Court, however, did not decide whether this interpretation would immunize a sale-repurchase transaction subsequent to the initial purchase[31]—a major concern which caused the *Stella* court to reject the "prior to" analysis in favor of the "simultaneous with" construction.[32] The *Stella* Court was concerned because an individual could purchase more than ten percent of a corporation's stock, obtain inside information because of his newly acquired insider status, and then based on this inside information reduce his stockholding to below ten percent and repurchase the stock to above ten percent at a profit. Because immediately prior to this repurchase the individual was not a ten percent owner, this would not be a §16(b) purchase. The Court discounted the need for such concern today because § 10(b) and Rule 10b-5[33] would remedy any actual misuse of inside informa-

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pectation on his part in entering into such transaction of holding the security purchased for a period exceeding six months.

[26] *Hearings on H. R. 7852 and H. R. 8720 Before the House Comm. on Interstate and Foreign Commerce*, 73d Cong., 2d Sess. 133 (1934); *See* Hecker, *supra* note 3, at 261-69.

[27] *See* § 16(b) as enacted, 15 U.S.C. § 78p(b) (1970). Although the original version dealt only with purchase-sale transactions, the act was amended to include sale-purchase transactions because inside information as to bad financial condition of a corporation could be taken advantage of as well as good information. *See Hearings on S. Res. 84, S. Res. 56, and S. Res. 97 Before the Senate Comm. on Banking and Currency*, 73d Cong., 2d Sess. pt. 15 at 6557-58 (1934).

[28] The exemptive provision by its terms applies only to beneficial owners. *See* 15 U.S.C. § 78p(b) (1970).

[29] 96 S. Ct. at 516-17.

[30] *Id.*

[31] The Court stated it would express no view on this issue. *Id.* at 515 n.15.

[32] Stella v. Graham-Paige Motors Corp., 104 F. Supp. 957, 959 (1952).

[33] 15 U.S.C. § 78j(b) (1970); 17 C.F.R. § 240.10b-5 (1975); *See* Comment, 7 RUT.-CAMDEN L. J. 104, *supra* note 11 at 121-23.

tion in such a transaction. Additionally, the Court cited the Ninth Circuit's opinion in *Provident*[34] which held that a "prior to" construction in a purchase-sale sequence did not foreclose a "simultaneous with" interpretation in a sale-repurchase transaction.[35] Although the Ninth Circuit recognized that such a conclusion did not "provide a consistent construction of the language 'at the time' for both initial and the closing transactions," it reasoned that such construction was nevertheless "consistent with the rationale of section 16(b)—a consistency . . . more important than the consistency of terms."[36] The Seventh Circuit, however, disagreed that such a dual construction was compatible with Congress' intent. In *Allis-Chalmers Manufacturing Co. v. Gulf & Western Industries, Inc.*,[37] decided shortly before the Supreme Court's *Provident* decision, it adopted an analysis of § 16(b) which precluded the need for a dual construction of the exemptive provision in subjecting a sale-repurchase sequence to § 16(b) liability.

In *Allis-Chalmers*, the Seventh Circuit also held that an initial purchase creating beneficial ownership was not a § 16(b) purchase. However, the court did not rely on the exemptive provision, but rather concluded that § 16(b) contemplated insider status prior to any short swing transaction.[38] The court reasoned that the legislative history of the section indicated that Congress intended to treat a sale and purchase or purchase and sale as a single, conceptual unit, and that it did not intend § 16(b) to apply to each separate part of a transaction.[39] The focus of the section was to be on insider status before entering into the two-part transaction. Thus, an initial purchase creating beneficial ownership and a subsequent sale could not be a § 16(b) transaction. However, since beneficial ownership existed prior to entering into the two-part transaction, a sale and repurchase transaction within six months would be a § 16(b) transaction. The *Allis-Chalmers* decision, however, ignores the distinction which the exemptive provision draws between beneficial owners and directors and officers. Under the court's holding, the beginning purchases or sales in short swing transactions by directors and officers prior to their gaining insider status would not be § 16(b) purchases. However,

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[34] 96 S. Ct. at 515.

[35] 506 F.2d 601, 614-15 (9th Cir. 1974).

[36] *Id.* at 614.

[37] 527 F.2d 335 (7th Cir. 1975).

[38] *Id.* at 346-49. The court's analysis included a requirement of insider status prior to a transaction for officers and directors as well as for beneficial owners.

[39] *Id.* at 346-47.

other cases dealing with such situations have held the director or officer liable under § 16(b).[40]

The reason for this is that § 16(b) was intended to prevent both double and single transaction abuse when dealing with directors and officers but only double transaction abuse when dealing with beneficial owners. The rationale for this distinction is that directors and officers are considered to have more ready access to corporate inside information and to have greater influence over corporate decisions affecting stock values than ten percent stockholders.[41]

The Seventh Circuit's statutory construction of the exemptive provision raises additional problems. The court concluded that the exemptive provision required a finding of insider status only prior to the initial transaction and did not require a finding of insider status at the time of the closing transaction. It reasoned that the language "both at the time of purchase and sale, or sale and purchase . . ." should be construed as referring to the two types of transactions and not as referring to the separate components of the two types of transactions.[42] Such a construction, however, renders the exemptive provision surplusage—the language of the section already reaches both types of transactions.[43] Moreover, the legislative history of § 16(b) indicates that the language "purchase and sale, or sale and purchase" refers to one type transaction, a short swing transaction, that can be accomplished in two ways.[44] Finally, the court's conclusion that the exemptive provision does not require insider status at both the purchase and sale ends of a transaction is at odds with the Supreme

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[40] Kramer v. Ayer, CCH FED. SEC. L. REP. ¶ 95,483 (S.D.N.Y. 1976); Feder v. Martin Marietta Corp., 406 F.2d 260 (2d Cir. 1969), *cert. denied*, 396 U.S. 1036 (1970); Adler v. Klawans, 267 F.2d 840 (2d Cir. 1959); Marquette Cement Mfg. Co. v. Andreas, 239 F. Supp. 962 (S.D.N.Y. 1965).

[41] *See* Adler v. Klawans, 267 F.2d 840, 845 (1959). *Cf.* Foremost-McKesson, Inc. v. Provident Sec. Co., 96 S. Ct. 508, 520-21 (1976).

[42] 527 F.2d at 346-49.

[43] *See* 15 U.S.C. § 78p(b) (1970), which provides in the first sentence, that all insiders must return,

> "any profit realized by him from any purchase and sale, or any sale and purchase . . . ."

[44] In its original version, *see* note 24 *supra*, § 16(b) prohibited use of inside information only in purchase-sale transactions. Because sale-purchase transactions were equally subject to speculative abuse, the phrase was added. *See Hearings on H. R. 7852 and H. R. 8720 Before the House Comm. on Interstate and Foreign Commerce*, 73d Cong., 2d Sess. 133 (1934). By including sale-purchase transactions within the purview of § 16(b), the drafters were not changing the thrust of the statute, but merely indicating two ways to complete a short swing transaction.

Court's holding in *Reliance Electric Co. v. Emerson Electric Co.*[45] There, the Court held that the exemptive provision immunized a second sale from § 16(b) when a prior sale brought the seller's holding to below ten percent. The second sale was not considered a § 16(b) sale because at that time the seller was not a ten percent owner.[46]

Thus, the question remains whether the dual construction of the provision's language "at the time of" as espoused by the Ninth Circuit in *Provident* to reach sale-repurchase sequences is permissable under § 16(b). However, though it did not address this issue directly, the Supreme Court's holding in *Provident* as to the types of abuse which the section prohibits supports the Ninth Circuit's dual construction. The Supreme Court's construction of the language "at the time of" to mean "prior to" was the result of its conclusion that beneficial owners were to be liable under § 16(b) only for those transactions in which there was double transaction abuse.[47] This interpretation was not the result of a technical reading of the statute based on syntax or grammer, but was the means by which to implement congressional intent. Since a sale-repurchase sequence by a beneficial owner involves double transaction abuse, the question becomes how to interpret the provision to prevent such abuse. A "simultaneous with" construction referring to the repurchase implements congressional intent, just as a "prior to" construction referring to the initial purchase implements congressional intent. However, even if such a sale-repurchase transaction would not be within the purview of § 16(b), investors are protected from actual abuse by § 10(b) and Rule 10b-5. In noting the existence of these alternative means of remedying abuse in a sale-repurchase transaction, the Court made clear that an individual who completes a short swing sale-repurchase transaction based on inside information will be subject to liability.

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[45] 404 U.S. 418 (1972). The court's analysis is also at odds with the Supreme Court's analysis in *Provident*. Though the Supreme Court in *Provident* did not give an opinion regarding the *Allis-Chalmers* decision, 96 S. Ct. at 515 n.16 and 519 n.25, it did state that the purpose of the exemptive provision was to draw a distinction between beneficial owners and directors and officers. *Id.* at 516-17. Under the *Allis-Chalmers* decision, all insiders would be treated equally. Furthermore, a footnote in the Court's opinion indicates that it viewed the exemptive provision as referring to both components of a transaction. In discussing its holding in *Reliance Electric*, the Court noted that it had before it only the issue of construction of "at the time of purchase." *Id.* at 519 n.25. This seems to rebut the Seventh Circuit's conclusion that the exemptive provision does not require a "both ends" test of insider status.

[46] 404 U.S. at 422-27.

[47] *See* text accompanying notes 14-15 *supra*; notes 24-30 *supra*.

However, since this case was not presented, the Court declined to rule whether such a transaction would be subject to § 16(b) or § 10(b).[48]

### B. *Pragmatic Approach*

On its face, § 16(b) requires automatic application when an insider completes a profitable short swing transaction.[49] In *Kern County Land Co. v. Occidental Petroleum Co.*,[50] however, the Supreme Court distinguished between orthodox and unorthodox transactions.[51] When confronted with the latter-type transaction, the Court approved a subjective, or pragmatic, approach to determine if an insider would be liable under § 16(b).[52] This approach entailed a two part test which had to be satisfied before liability would attach. First, did the insider have access to inside information? Second, if so, did he have sufficient control over the transaction to enable him to misuse this information?[53] Before applying the *Kern* test, however, the courts must determine which transactions are unorthodox. Although the Supreme Court indicated the form of an unorthodox transaction,[54] it did not clearly set forth any standard to determine when the substance of the transaction is unorthodox.[55] Recent cases reveal that

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[48] *See* Hecker, *supra* note 3, at 270.

[49] Originally, the courts construed § 16(b) liability to vest on an objective measure of proof. Whenever an insider completed a profitable short swing transaction, § 16(b) liability attached, and no inquiry into actual misuse of inside information was necessary. *See* 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). For a history of the objective approach, *see* Blair v. Lamb, 363 F.2d 507, 518-19 (2d Cir. 1966), *cert. denied*, 385 U.S. 1002 (1967).

[50] 411 U.S. 582 (1973).

[51] The Court defined orthodox transactions as "traditional cash-for-stock transactions" and unorthodox transactions as "stock conversions, exchanges pursuant to mergers and other corporate reorganizations, stock reclassifications, and dealings in options, rights, and warrants." *Id.* at 593 n.24.

[52] For discussions concerning the evolution and application of the pragmatic approach, *see* Hazen; *The New Pragmatism Under Section 16(b) of the Securities Exchange Act*, 54 N.C. L. REV. 1 (1975); McElroy, *Pragmatic Disgorging of Insider Profits: A Review of Cases Reported Under Section 16(b)*, 7 ST. MARY'S L. J. 473 (1975); Wentz, *Refining a Crude Role: The Pragmatic Approach to Section 16(b) of the Securities Exchange Act of 1934*, 70 Nw. U. L. REV. 221 (1975). Note, *Section 16(b) Liability for Profits Realized From a Cash Purchase and Sale Within Six Months of Two Issuers Involved in an Intervening Reorganization*, 75 COLUM. L. REV. 1323, 1323-39 (1975); Note, *Involuntariness and Other Contemporary Problems Under Section 16(b) of the Securities and Exchange Act of 1934*, 27 HAST. L. J. 679, 679-94 (1976).

[53] 411 U.S. at 596-601.

[54] *See* note 48 *supra*, identifying the types of transactions considered unorthodox.

[55] The Court merely stated that in determining which transactions are within the

involuntariness of a transaction is an important factor in deciding whether a transaction is unorthodox.

In *Allis-Chalmers Manufacturing Co. v. Gulf & Western Industries, Inc.*,[56] Gulf & Western made two purchases and one sale of Allis-Chalmers stock within six months. The initial purchase was by tender offer and created ten percent beneficial ownership.[57] The second purchase involved a sale by Oppenheimer Fund, Inc. of its Allis-Chalmers stock holdings to Gulf & Western for 496,000 Gulf & Western stock warrants.[58] Gulf & Western successfully argued that the initial purchase was not a § 16(b) purchase.[59] However, the court rejected the argument that § 16(b) should not be automatically applied to the second purchase. Although the consideration involved was not cash, the court noted that this alone was insufficient to characterize the nature of the transaction as unorthodox.[60] Gulf & Western was not forced into an unwanted position with respect to the Allis-Chalmers stock purchase. Rather, it had voluntarily initiated the negotiations with Oppenheimer and had merely suggested that warrants, instead of cash, be used as consideration.[61] Furthermore, even had the court concluded that the second purchase was an unorthodox transaction, Gulf & Western would not have satisfied the

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purview of § 16(b), a court should inquire whether the transaction "may serve as a vehicle for the evil which Congress sought to prevent—the realization of short swing profits based upon access to inside information . . . ." 411 U.S. at 594.

[56] 527 F.2d 335 (7th Cir. 1975).

[57] *Id.* at 338-39.

[58] Oppenheimer sold 248,000 shares of Allis-Chalmers stock to Gulf & Western. *Id.* The sale by Gulf & Western was the result of other negotiations it had been conducting with White Consolidated Industries, Inc.; White agreed to purchase 3,248,000 shares of Allis-Chalmers stock from Gulf & Western for 250,000 shares of unregistered White common stock, $20 million, and a three month, 8 ½% promissory note for $93,680,000. *Id.* at 340.

[59] *See* text accompanying notes, 21-45 *supra*.

[60] 527 F.2d at 351. *See also*, Provident Securities Co. v. Foremost-McKesson, Inc., 506 F.2d 601, 604-05 (9th Cir. 1974), where the Ninth Circuit held that a transaction was not unorthodox merely because cash was not the consideration for the stock; 2 Loss, *supra* note 3, at 1072.

[61] 527 F.2d at 351. The Supreme Court's opinion in *Kern* also supports the Seventh Circuit's holding that the voluntariness of a transaction is determinative of its orthodox characterization. *See* Kern County Land Co. v. Occidental Petroleum Co., 411 U.S. 582, 600 (1973), where the Court stated:

> "We do not suggest that an exchange of stock pursuant to a merger may never result in § 16(b) liability. But the involuntary nature of Occidental's exchange, when coupled with the absence of the possibility of speculative abuse of inside information, convinces us that § 16(b) should not apply . . . ."

*Kern* test. Gulf & Western had been in close contact with the officers and directors of Allis-Chalmers during the entire negotiation period, thus having access to inside information. Finally, the disposition of its holdings was subsequent to its receipt of inside information from Allis-Chalmers, thus creating a possibility of abuse.[62]

In another recent case, the court held that the *Kern* pragmatic approach did apply based on a determination that the acquisition was involuntary. In *Morales v. Mapco, Inc.*,[63] Ross, the financial vice-president of Mapco, purchased 3616 Mapco common stock warrants. More than six months subsequent to his last purchase, Ross exercised these warrants and then almost simultaneously sold the shares he had received.[64] The court noted that the exercise of the warrants was not a "traditional 'cash-for-stock' purchase" and that this was an involuntary conversion to the extent that Ross would have suffered a significant loss had he not converted.[65] Thus, the court concluded that the transactions were unorthodox and held that under *Kern* neither the acquisition nor the sale of the shares were transactions to which § 16(b) applied. Since the value of the warrants and the value of the stock were economic equivalents—the conversion did not change Ross's proportioned equity ownership—he could not have benefited from the misuse of any inside information in this acquisition.[66] Furthermore, since the stock was sold immediately after conversion, the "simultaneous nature of the exchange" made it impossible for Ross to base the sale on inside information.[67]

In noting the impossibility for misuse of inside information, the *Mapco* court omitted the first part of the *Kern* test by not inquiring into Ross' actual access to inside information. However, the court's

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[62] 527 F.2d at 351.

[63] [1974-1975 Transfer Binder] CCH FED. SEC. L. REP. ¶ 95,094 (N.D. Okl. 1975).

[64] From March, 1964, to June, 1971, Ross purchased the warrants. The warrants were automatically converted into one-half share of Mapco common stock on April 1, 1972. Alternatively, a warrant plus $9.00 could be converted into one share prior to April 1, 1972. Ross exercised all his warrants under the alternative conversion plan. However, he did not sell all the stock he received upon conversion. He sold only 900 shares. *Id.* at 97,876-77.

[65] *Id.* at 97,879. Involuntariness has been defined as the absence of any other "realistic alternative" to the completed transaction. A cash-for-stock transaction which would subject an individual to automatic § 16(b) liability is not a "realistic alternative." *See* Kern County Land Co. v. Occidental Petroleum Co., 411 U.S. 582, 600 (1973).

[66] [1974-1975 Transfer Binder] CCH FED. SEC. L. REP. ¶ 95,094, at 97,878-79; *See* Ferraiolo v. Newman, 259 F.2d 342, 345-46 (6th Cir. 1958), *cert. denied*, 359 U.S. 927 (1959).

[67] [1974-1975 Transfer Binder] CCH FED. SEC. L. REP. ¶ 95,094, at 97,879.

apparent presumption[68] that he did seems proper. The presumption of an insider's access to inside information is based partly on the corporate realities that officers, directors, and ten percent equity owners are in a position to know, participate in, and influence the important decisions of a corporation.[69] In *Kern*, the Supreme Court recognized that not all ten percent owners may be in such a position. For example, a ten percent owner in a hostile relationship with majority shareholders will not have access to inside information.[70] However, there is no reason to rebut the presumption that officers and directors have access to inside information because the nature of their job requires knowledge of and participation in corporate decisions. The existence of the exemptive provision supports this distinction between the directors' and officers' relationship with the issuer and the ten percent owners' relationship with the issuer. Indeed, courts have recognized that officers and directors are more knowledgeable of and have more influence over corporate decisions than do ten percent owners by the very nature of their relation to the corporation.[71]

Together the *Mapco* and *Allis-Chalmers* decisions indicate that the mere form of a transaction will not render it unorthodox. An important consideration under *Kern* is whether the challenged transaction was entered into voluntarily. Because § 16(b) cannot deter involuntary transactions, to impose liability automatically in such situations will not further the section's purpose. Furthermore, the pragmatic approach resulted from criticism of the harshness resulting from automatic application of § 16(b). Since application of the section seems the harshest when an individual can not help but satisfy the objective criterion of the section, a subjective determination whether he misused inside information in such situations is fair.

### *C. Section 16(b) Profits*

In order "to squeeze all possible profits out of [§ 16(b)] transactions,"[72] the amount of profits recoverable by a corporation in a §

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[68] The court stated that to have held Ross subject to § 16(b) "would penalize a holder of securities for following sound economic principles merely because he serves the corporation in an official capacity, and thereby has access to inside information." *Id.*

[69] *See* S. REP. No. 1455, 73d Cong., 2d Sess. 55-68 (1934); *Hearings on S. Res. 84, S. Res. 56, and S. Res. 97 Before the Senate Comm. on Banking and Currency*, 73d Cong., 2d Sess., pt. 15, at 6555 and pt. 16, at 7741-42 (1934). *Cf.* Foremost-McKesson, Inc. v. Provident Securities Corp., 96 S. Ct. 508 (1976).

[70] Kern County Land Co. v. Occidental Petroleum Corp., 411 U.S. 582, 598 (1973).

[71] Adler v. Klawans, 267 F.2d 840, 845 (2d Cir. 1959).

[72] Smolowe v. Delendo Corp., 136 F.2d 231, 239 (2d Cir. 1943), *cert. denied*, 320

16(b) action is calculated on the lowest price in, highest price out basis.[73] Such a high standard deters insiders from furthering their own self interest at the expense of the fiduciary duty they owe their corporation and precludes the possibility of abuse that is inherent in alternative methods of profit computation.[74] Recently, a New York District Court utilized this rationale in determining how § 16(b) profits are to be paid.

In *Lewis v. Arcara*,[75] defendant Arcara, a vice-president of Capital Cities Communication, Inc., realized a profit on a short-swing purchase and sale of Capital Cities stock. He did not contest that the profit was recoverable, and he and Capital Cities reached an out-of-court settlement whereby Capital Cities accepted a five-year, interest-bearing note as payment for the profits.[76] The court, however, ruled that the purposes of the section required that profits be immediately disgorged.[77] Although in this case Arcara and Capital Cities

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U.S. 751 (1944); 2 Loss, *supra* note 3, at 1062-63.

[73] *Id.* Under this rule, profits are calculated in the following fashion:

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

Feldman and Rubin, *Statutory Inhibitions Upon Unfair Use of Corporate Information by Insiders*, 95 U. PA. L. REV. 468, 482 (1947).

[74] 136 F.2d at 239. Alternative methods of profit computation include a first-in, first-out rule (FIFO) and a rule whereby the courts average the purchase and sale prices of the stock traded during a six-month period. Under FIFO, an individual could evade § 16(b) liability by maintaining a large inventory of the shares at all times. Under the averaging rule, an individual who purchased stock at a high price could, after the price fell, within six months purchase more at a low price based on inside information that the price was going to rise. The individual could thus recoup any losses by selling after the price rise and incur no § 16(b) liability. Such a scheme would work because an insider could buy 5,000 shares at 100 and purchase another 5,000 shares when the market fell to 70 (four months later) on inside information of a future price rise and sell when the price rises to 80 (within one month of second purchase, five of first) incurring no § 16(b) liability because his average cost was 85. *See* 2 Loss, *supra* note 3, at 1062 n.114.

[75] CCH FED. SEC. L. REP. ¶ 95,238 (S.D.N.Y. 1975).

[76] *Id.* at 98,251.

[77] The court noted that in order to insure a deterrent effect the section was intended to prevent even the possibility for abuse in insider trading. By its terms, § 16(b) requires return of profits regardless of motive or actuality of abuse. If good faith has

had acted in good faith, allowance of deferred payment schemes under § 16(b) "would open the door to potential abuses."[78] Since a corporation acts through its insiders, to permit such a method of returning § 16(b) profits would only encourage insiders to deal amongst themselves in order to accommodate to the insider the least burdensome means of payment.[79] Furthermore, a deferred payment scheme would soften the impact of § 16(b) in requiring full payment of profits to the corporation and, therefore, decrease the deterrent effect of the statute.

In calculating the profits to be returned, courts are often faced with problems of valuing property other than cash that is used as consideration to pay for securities in a § 16(b) transaction. Usually, the valuation is based on expert opinion as to the fair market value of the property at the time of the transaction.[80] However, problems arise in deciding what the experts should consider. In *Allis-Chalmers Manufacturing Co. v. Gulf & Western Industries, Inc.*,[81] the Seventh Circuit considered three means by which to value unregistered warrants and stock—the low price, the volume weighted average price, or the high price for registered stocks and warrants on the days of the § 16(b) transaction.[82] The plaintiff argued that § 16(b)'s policy to recapture all possible profits from the transaction required the court to value the warrants used to purchase the § 16(b) securities under the low price figure and the stock received for selling the securities under the high price figure. The Court disagreed and based its valuation of both on their volume weighted average price.[83]

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nothing to do with determining § 16(b) liability, it shouldn't have anything to do with paying the profits. *Id.* at 98,252-53. *See also* Schur v. Salzman, 365 F. Supp. 725 (S.D.N.Y. 1973), where it was held that if an insider withholds profits for a substantial period of time by raising frivilous defenses, the insider must pay a penalty interest.

[78] *Id.* at 98,252.

[79] *Id. See also*, Lewis v. Wells, 325 F. Supp. 382 (S.D.N.Y. 1971), where it was held that a § 16(b) profit settlement for less than full amount of profits was not permitted under the section, regardless of any good faith.

[80] *E.g.*, Allis-Chalmers Mfg. Co. v. Gulf & Western Industries, Inc., 527 F.2d 335, 352 n.17 (7th Cir. 1975); Kramer v. Ayer, CCH FED. SEC. L. REP. ¶ 95,483, at 99,442-43 (S.D.N.Y. 1976).

[81] 527 F.2d 335 (7th Cir. 1975).

[82] Low price means the lowest price paid for the security traded on the exchange on a given day. High price means the highest price paid. Volume weighted average price is determined by dividing the total amount paid for all the shares traded by the number of shares traded. *Id.* at 352-53 n.19.

[83] *Id.* at 354. The court also held that evidence of full payment of a debt obligation is conclusive as to its value. To have ruled otherwise and permitted a discounted valuation to be used in computing profits after full payment would have enabled the insider to retain for himself the amount of the discount, a realized profit. *Id.* at 356-