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Vii. Section 16(B)

under the federal securities laws than adequate disclosure of the transaction, the problems created by a corporation going private have only recently become acute. In response to the controversy, the Commission has proposed two alternative rules to regulate going private transactions.[50] Consequently, the possibility still exists that the inequities engendered by going private may be controlled under the existing provisions of the federal securities laws.

VII. SECTION 16(b)

A. *Introduction*

To prevent insiders from profitably misusing corporate information,[1] § 16(b)[2] of the Securities Exchange Act of 1934[3] permits the corporation to recover insider profits on purchases and sales of the corporation's securities. Two presumptions created by the section aid

663, 699-705 (1974).

[50] The rules, Rules 13e-3A and 13e-3B, basically require disclosure of certain information when an issuer intends to go private. Rule 13e-3A requires that the price offered for such securities must be "fair" as determined by two independent experts. Rule 13e-3B contains the same general fairness and disclosure requirements, but is of somewhat more limited scope and does not provide for fair market value determination by independent experts. The proposed rules will be considered and discussed during hearings conducted by the SEC for the purpose of investigating going private transactions. The hearings are to be held in April, 1975. SEC Securities Act Release No. 5567 (February 6, 1975).

[1] For a discussion of the legislative history of § 16(b), see Note, 32 WASH. & LEE L. REV. 699, 708-10 (1975).

[2] 15 U.S.C. § 78p(b) (1970). Section 16(b) provides that the corporation or one of its shareholders may sue any statutory insider, an 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 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. It is important to note that § 16(b) purchasing and selling transactions may be in any order. *See* Provident Sec. Co. v. Foremost-McKesson, Inc., 506 F.2d 601, 610 (9th Cir. 1974), *cert. granted*, 43 U.S.L.W. 3451 (U.S. Feb. 18, 1975) (No. 74-742).

[3] 15 U.S.C. §§ 78a-78hh (1970). One of the purposes of the 1934 Act is to regulate the practices employed in trading the securities subject to the Act. Such regulation "is designed to protect the investing public by maintaining fair and open markets for the buying and selling of securities . . . ." Cook & Feldman, *Insider Trading Under the Securities Exchange Act*, 66 HARV. L. REV. 385 (1953). The legislative history of § 16(b) includes H.R. REP. NOS. 1383, 1838, 73d Cong., 2d Sess. (1934); S. REP. NOS. 792, 1455, 73d Cong., 2d Sess. (1934).

the plaintiff in establishing his case. First, a corporate insider is presumed to have access to inside information.[4] Second, he is presumed to have misused this information if he conducts profitable purchasing and selling transactions within a six month period.[5] In spite of these presumptions, however, the section does not provide automatic recovery in all instances of insider trading. Problems arise in determining who is an insider, what transactions are sales and purchases, and whether the presumptions of access to inside information and concurrent abusive use are conclusive in all cases.[6]

B. Section 16(b) Insiders

A § 16(b) insider includes any officer, director,[7] or beneficial owner of more than ten percent of any class of a corporation's equity securities registered under the 1934 Act.[8] By broadly interpreting the definition, the courts have attempted to include within the scope of the section as many cases of insider abuse as possible.

(1). Directors

In cases involving directors, the courts have held that a defendant need not have been a director at the time of both the purchase and sale transactions allegedly yielding profits recoverable under § 16(b).[9]

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[4] Provident Sec. Co. v. Foremost-McKesson, Inc., 506 F.2d 601 (9th Cir. 1974), *cert. granted*, 43 U.S.L.W. 3451 (U.S. Feb. 18, 1975) (No. 74-742).

[5] 506 F.2d at 611. Note, *Securities Exchange Act Section 16(b): Fourth Circuit Harvests Some Kernels of Gold*, 42 FORDHAM L. REV. 852, 856 (1974); Comment, *Section 16(b): An Alternative Approach to the Six-Month Limitation Period*, 20 U.C. L.A. L. REV. 1289, 1295-96 (1973). The presumption of actual abuse can be rebutted in some instances, however. *E.g., Kern County Land Co. v. Occidental Petroleum Corp.*, 411 U.S. 582, 593-95 (1973).

[6] For practical guides to § 16(b)'s application, *see* Deitz, *A Practical Look at Section 16(b) of the Securities Exchange Act*, 43 FORDHAM L. REV. 1 (1974); Lang and Katz, *Section 16(b) and "Extraordinary" Transactions: Corporate Reorganizations and Stock Options*, 49 NOTRE DAME LAW. 705 (1974).

[7] 15 U.S.C. § 78p(b) (1970).

[8] 15 U.S.C. § 78p(a)-(b) (1970).

[9] In Adler v. Klawans, 267 F.2d 840 (2d Cir. 1969), the defendant purchased securities of a corporation of which he later became a director. Subsequent to his becoming a director, and within six months of the purchase, the defendant sold his securities at a profit. The court found that although § 16(b) requires that a ten percent beneficial owner be such at both the purchase and sale transactions, there was no similar requirement for officers and directors. *See* 15 U.S.C. § 78p(b) (1970). This reasoning, coupled with the broad remedial purpose of the section, led the court to conclude that the defendant should be held liable. *Accord*, Marquette Cement Mfg. Co. v. Andreas, 239 F. Supp. 962 (S.D.N.Y. 1965).

Feder v. Martin Marietta Corp., 406 F.2d 260 (2d Cir. 1969), *cert. denied*, 396 U.S.

Recently, however, a district court decision, *Lewis v. Varnes*,[10] confirmed that the defendant must be a director at the time of at least one of the transactions. The *Lewis* defendant had received stock options while an officer and director of the issuing corporation but did not exercise the options until retirement from these positions. Thus the purchase of the securities and their sale less than six months later occurred after the defendant had ended his insider status. Following an earlier district court decision,[11] the *Lewis* court did not allow recovery of the defendant's profits.[12]

A second fact situation involving definitional problems arises when one spouse who is a corporate director purchases or sells the corporation's securities within six months of a sale or purchase in the same securities by the nondirector spouse. In the 1974 case *Whiting v. Dow Chemical Co.*,[13] a director of Dow exercised options to purchase the company's shares less than six months after his wife sold a portion of her own Dow holdings. To determine whether the profits[14] were recoverable under § 16(b), the district court applied tests set forth in a SEC Release which specified when one spouse would be considered the beneficial owner of the other spouse's securities for the purpose of the § 16(a) reporting requirements.[15] The court found that

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1036 (1970) presented the reverse fact situation. The director resigned from the corporation's board prior to the sale of stock which was within six months of a preresignation purchase. The court found that there was a potential for abusive use of inside information by a director who resigned before the final transaction and that § 16(b) liability should therefore attach. *Id.* at 268. *But see* Comment, *Stock Exchanges Pursuant to Corporate Consolidation: A Section 16(b) "Purchase or Sale"?* 117 U. PA. L. REV. 1034, 1041-42 n.39 (1969).

[10] [1973-1974 Transfer Binder] CCH FED. SEC. L. REP. ¶ 94,343 (S.D.N.Y. 1974).

[11] Levy v. Seaton, 358 F. Supp. 1 (S.D.N.Y. 1973).

[12] CCH FED. SEC. L. REP. ¶ 94,343 at 95,159.

[13] Whiting v. Dow Chem. Co., CCH FED. SEC. L. REP. ¶ 94,923 (S.D.N.Y. Dec. 24, 1974) (Director Whiting sought a declaration of whether he was liable under § 16(b) and Dow counterclaimed for his profits).

[14] The alleged profits resulted when Mrs. Whiting sold her shares at a higher price than that paid by her husband when he exercised the stock options. *Id.* at 97,174.

[15] SEC Securities Exchange Act Release No. 7793 (Jan. 19, 1966) provides:

> Generally a person is regarded as the beneficial owner of securities held in the name of his or her spouse . . . . Absent special circumstances such relationship ordinarily results in such person obtaining benefits substantially equivalent to ownership, e.g., application of the income derived from such securities to maintain a common home, to meet expenses which such person otherwise would meet from other sources, or the ability to exercise a controlling influence on the purchase, sale, or voting of such securities. Accordingly, a person ordinarily should include in his reports filed pursuant to Section 16(a) securities held in the name of a spouse . . . .

although Mr. and Mr. Whiting maintained separate investment accounts, they did communicate concerning financial matters and acted together when joint transactions were beneficial. In addition, the nondirector spouse paid some of the family expenses from her investment profits. The court concluded that the close connection between the spouses' investments was sufficient to make the director spouse the beneficial owner of his wife's shares for § 16(a) purposes and, by analogy, for § 16(b) purposes as well.[16] Thus Dow could recover the profits on the sale and subsequent purchase of the corporation's shares.

The result seems proper because the Whitings' discussion of financial matters, when coupled with their joint transactions in the past, made it possible for the couple to carry out short swing trades based on inside information. However, courts deciding cases in the future should not interpret the *Whiting* court's use of the SEC Release tests to mean that a director spouse's liability may be founded solely on his enjoyment of the nondirector spouse's investment profits. Before allowing § 16(b) recovery, a court should find some indication that the corporate insider could communicate nonpublic information to his spouse who in turn could act on the basis of that information.[17] A showing that the defendant merely enjoyed the profits of his spouse's investments would not sufficiently demonstrate a possibility of misuse of inside information.[18]

(2). Ten Percent Beneficial Owner

The term "such beneficial owner" in § 16(b)[19] is defined in § 16(a) as every person who is the beneficial owner of more than ten percent of any class of the corporation's equity securities registered under the

[16] *Compare* Blau v. Potter, [1973 Transfer Binder] CCH FED. SEC. L. REP. ¶ 94,115 (S.D.N.Y. 1973) (citation omitted) (no § 16(b) liability where husband's and wife's estates were organized and managed separately and wife made no contribution to family expenses).

[17] Provident Sec. Corp. v. Foremost-McKesson Inc., 506 F.2d 601, 612-14 (9th Cir. 1974), *cert. granted*, 43 U.S.L.W. 3451 (U.S. Feb. 18, 1975) (No. 74-742).

[18] SEC Securities Exchange Act Release No. 7793 (Jan. 19, 1966), *see* note 15 *supra*, indicates that an insider spouse would be required to report the outsider spouse's stock ownership even if the only connection between the spouses' investments was a sharing of the profits for the benefit of the family. It should be noted, however, that § 16(a), to which Release 7793 pertains, has a broader scope than § 16(b). Thus, a defendant might not be liable under § 16(b) for profits resulting from transactions involving his spouse's shares even though he has reported beneficial ownership of the shares pursuant to § 16(a). *See* SEC Securities Exchange Act Release No. 7824 (Feb. 14, 1966).

[19] 15 U.S.C. § 78p(b) (1970).

1934 Act.[20] To be liable for his profits under § 16(b), however, the defendant must have been such a beneficial owner both at the time of the purchasing and the selling transactions.[21] The question arose in early § 16(b) cases whether the transaction creating beneficial ownership would also serve as a § 16(b) purchase. Judge Kaufman applied what has become the majority rule in *Stella v. Graham-Paige Motors Corp.*,[22] deciding that in order to prevent most of the abuses which the section was designed to check, the statutory phrase "at the time of" must be interpreted to mean ten per cent ownership created simultaneously with the first § 16(b) purchase.[23]

Recently, however, the Ninth Circuit in *Provident Securities Corp. v. Foremost-McKesson, Inc.*[24] departed from the *Stella* rule, holding that § 16(b) liability could be imposed only upon persons who were ten percent owners prior to the first § 16(b) transaction. The court reasoned that the abuse which Congress intended § 16(b) to check was insider misuse of corporate information to carry out profitable short term buying and selling by which the insider does not

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[20] *Id.* § 78p(a).

[21] *Id.* § 78p(b).

[22] 104 F. Supp. 957 (S.D.N.Y. 1952), *remanded*, 232 F.2d 299 (2d Cir.), *cert. denied*, 352 U.S. 831 (1956).

[23] The *Stella* rule was intended to prevent a person from purchasing a large block of stock, then selling down to bring his ownership below ten percent, and then repeating the process. 104 F. Supp. at 959 Cook & Feldman, *Insider Trading Under the Securities Exchange Act*, 66 HARV. L. REV. 612, 631-32 (1953). The *Stella* rule controls in most courts. *E.g.*, Colonia Realty Corp. v. MacWilliams, 381 F. Supp. 26 (S.D.N.Y. 1974); Allis-Chalmers Mfg. Co. v. Gulf & Western Indus., Inc., 372 F. Supp 570, 576 (N.D. Ill. 1974).

[24] 506 F.2d 601 (9th Cir. 1974), *cert. granted*, 43 U.S.L.W. 3451 (U.S. Feb. 18, 1975) (No. 74-742).

On September 25, 1969, Provident Securities agreed to transfer most of its assets to Foremost-McKesson in exchange for cash and convertible debentures. The agreement was closed on October 15. On October 21, Provident signed an agreement with an underwriter to sell about half of the debentures it received from Foremost at a profit to Provident of $366,666.66. Provident distributed the remaining debentures to its shareholders on October 24, and at that time ended its beneficial ownership of more than ten percent of a class of Foremost equity securities. Finally, on October 28, the underwriter agreement signed on October 21 was closed and Provident received payment for the debentures sold.

The initial question for the court was whether the October 21 underwriter agreement or the October 28 closing date was the sale date of the Foremost debentures. The question was crucial to Provident's § 16(b) liability because Provident was a ten percent owner on October 21, but not on October 28.The court held the October 21 date to be the sale date and then proceeded to the question of whether the exchange of Provident's assets for Foremost debentures, which made Provident a ten percent owner, could also be a § 16(b) purchase.

intend to alter his longterm investment in the corporation's securities.[25] Since § 16(b) creates a conclusive presumption that an insider intended to speculate in short swing transactions,[26] the section should apply only to insiders who probably would have access to inside information.[27] Unless a person is an officer or a director, he is not presumed to be an insider under the section until he owns more than ten percent of a corporation's securities.[28] Thus the transaction which created ten percent ownership could not have been carried out on the basis of information received because the person was an insider.[29] Therefore, the *Provident Securities* court held that to be liable under § 16(b), the defendant must have been a ten percent owner prior to the first § 16(b) transaction. However, to prevent ten percent owners from speculating by selling their holdings to less than ten percent and then repurchasing on the basis of inside information, the court interpreted "at the time of" to mean ten percent ownership existing simultaneously with the last transaction.[30]

The Ninth Circuit's restrictive interpretation of "at the time of" is consistent with the views of those commentators who advocate limiting the scope of § 16(b).[31] The opportunities for misuse of inside information inherent in some transactions which would be excluded

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[25] The court noted that "[t]he section was directed against an insider who has no intention of changing his investment relationship to the corporation, but rather has an 'intention or expectation' to purchase and sell the stock within six months." 506 F.2d at 609. *See* Comment, *Section 16(b): An Alternative Approach to the Six-Month Limitation Period*, 20 U.C.L.A. L. REV. 1289, 1296-97 (1973); Note, *Insider Liability for Short Swing Profits: The Substance and Function of the Pragmatic Approach*, 72 MICH. L. REV. 592, 598-607 (1974).

[26] 506 F.2d at 611.

[27] *Id.* at 612.

[28] *Id.* at 609, 614.

[29] *Id.* The court noted that a transaction may be based on inside information received by means other than a person's inside relationship to the issuer corporation. Presumably, such an abuse of inside information would be actionable under Rule 10b-5. *See* Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 495 F.2d 228, 237-38 (2d Cir. 1974).

[30] The first transaction may be either a purchase or a sale and the second transaction a sale or a purchase. *See* note 2 *supra*.

[31] According to one writer, "There is no longer any reason for the federal courts to be harsh and objective in interpreting and applying section 16(b). Everything that this section was designed to accomplish, and much more, is presently being accomplished under section 10(b) and rule 10b-5." Lowenfels, *Section 16(b): A New Trend in Regulating Insider Trading*, 54 CORNELL L. REV. 45, 63 (1968). *See also* Comment, *Reliance Electric, Occidental Petroleum, and Section 16(b): Interpretive Quandary Over Mergers*, 51 TEX. L. REV. 89, 99-100 (1972); Note, *Reliance Electric and 16(b) Litigation: A Return to the Objective Approach?*, 58 VA. L. REV. 907, 915 (1972).

from the scope of § 16(b) by the *Provident Securities* rule make the wisdom of such a limitation questionable, however. In *Newmark v. RKO General, Inc.*,[32] for example, the defendant RKO made a single purchase of securities of Central Airlines, a corporation which planned to merge with Frontier Airlines, a subsidiary controlled by RKO.[33] Following the *Stella* rule,[34] the court held that the purchase made RKO owner of more than ten percent of Central's shares and was therefore a § 16(b) purchase which could be matched with a sale less than six months later.[35] The result in *Newmark* was consistent with the policy of foreclosing the potential for speculative abuse, because RKO's inside position in Frontier gave it access to nonpublic information of Central while the two airlines were negotiating a merger agreement.[36] Under the *Provident Securities* rule, however, the acquisition of Central shares could not have been a § 16(b) purchase because RKO was not a ten percent owner prior to the transaction. Thus the Ninth Circuit's rule would exclude from the scope of § 16(b) some transactions which might involve an insider's profitable misuse of nonpublic information.

Presumably, RKO coud have been held liable under § 10(b) and Rule 10b-5[37] if the plaintiff could have demonstrated misuse of inside information. The presumptions in favor of a § 16(b) plaintiff, however, make the elements of a Rule 10b-5 suit and a § 16(b) case very different. Under § 16(b), the defendant is presumed to have access to inside information which he intends to misuse[38] if he carries out purchase and sale transactions within six months.[39] In contrast, the Rule 10b-5 plaintiff must show scienter,[40] possession of undisclosed material inside information by the defendant, and the abusive use of this inside information to the plaintiff's harm.[41] Since one of the primary purposes of the 1934 Act is to maintain fair and open markets

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[32] 425 F.2d 348 (2d Cir.), *cert. denied*, 400 U.S. 854 (1970).

[33] *Id.* at 351-52.

[34] *See* text accompanying notes 22-23 *supra*.

[35] 425 F.2d 355-56.

[36] *Id.* at 353-54.

[37] 15 U.S.C. § 78j(b) (1970); 17 C.F.R. § 240.10b-5 (1974).

[38] *See* notes 2, 4-5 and accompanying text *supra*.

[39] The presumption of abuse is not conclusive in cases involving unorthodox transactions. *See* note 5 *supra*.

[40] The courts disagree on the meaning of scienter, but it would seem that in most federal circuits today, more than negligence is required. *See* notes 2-3 and accompanying text at 750-51.

[41] *See, e.g.*, Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 495 F.2d 228 (2d Cir. 1974).

by forbidding trading on nonpublic information,[42] it would seem preferable that transactions such as those in *Newmark* and *Provident Securities* remain within the scope of § 16(b), thereby facilitating private suits to enforce the Act's policies.

C. *Purchase and Sale*

To be liable under § 16(b), a defendant must have engaged in at least two transactions which entailed the purchase and sale of securities.[43] Where the transaction in question involves the exchange of securities for cash a purchase or sale clearly has taken place. However, when the transaction consists of an unorthodox event such as an exchange of stock pursuant to a merger agreement or the conversion of one security into another,[44] the problem arises of determining whether the transaction is either a § 16(b) purchase or sale.

Early cases interpreted the terms "purchase"[45] and "sale"[46] broadly. *Park & Tilford, Inc. v. Schulte*,[47] for example, held that a conversion of preferred stock into common constituted a purchase of the common which could be matched with a later sale. However, this broad interpretation of the statutory language included within the scope of § 16(b) some unorthodox transactions which could not have involved misuse of inside information. Thus, to avoid "purposeless harshness" resulting from a mechanical application of § 16(b), many courts determined whether a transaction could be used for speculative purposes before allowing recovery.[48] This refinement, which has

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[42] 15 U.S.C. § 78p(b) (1970). *E.g.*, Smolowe v. Delendo Corp., 136 F.2d 231, 235 (2d Cir.), *cert. denied*, 320 U.S. 751 (1943).

[43] 15 U.S.C. § 78p(b) (1970).

[44] In addition to merger exchanges and conversions, the Supreme Court in Kern County Land Co. v. Occidental Petroleum Corp., 411 U.S. 582 (1973), mentioned as constituting unorthodox transactions exchanges pursuant to corporate reorganizations, "stock reclassifications and dealings in options, rights and warrants." *Id.* at 593 n.24. The list of unorthodox transactions is probably not all-inclusive, however. Provident Sec. Corp. v. Foremost-McKesson, Inc., 506 F.2d 601, 604 (9th Cir. 1974), *cert. granted*, 43 U.S.L.W. 3451 (U.S. Feb. 18, 1975) (No. 74-742). *See* 2 L. Loss, Securities Regulation 1069 (2d ed. 1961).

[45] The 1934 Act defined "purchase" as "any contract to buy, purchase, or otherwise acquire." 15 U.S.C. § 78c(13) (1970).

[46] The term "sale" includes "any contract to sell or otherwise dispose of." *Id.* § 78c(14).

[47] 160 F.2d 984 (2d Cir.), *cert. denied*, 332 U.S. 761 (1947). *See* 17 C.F.R. § 240.16b-9 (1974).

[48] For a summation of the history of the objective approach to § 16(b), *see, e.g.*, Blau v. Lamb, 363 F.2d 507, 518-19 (2d Cir. 1966), *cert. denied*, 385 U.S. 1002 (1967). Most of the circuit courts, with the notable exception of the Third Circuit, Heli-Coil

been termed the subjective approach in contrast to the automatic, objective approach of *Park & Tilford*, was approved by the Supreme Court in *Kern County Land Co. v. Occidental Petroleum Corp.*[49] Before applying § 16(b), the *Kern* court used a two-part test to determine if the unorthodox transaction[50] involved presented an opportunity for abuse.[51] The Court inquired first whether the defendant had access to inside information of the plaintiff corporation[52] and second, whether the defendant had enough control over the transaction involved to allow it to misuse undisclosed information profitably. Finding neither part of the test met, the Court affirmed the Second Circuit's holding for the defendant.[54]

How courts apply the *Kern* test for ascertaining whether an unorthodox transaction[55] is a § 16(b) purchase or sale will determine

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Corp. v. Webster, 352 F.2d 156 (3d Cir. 1965), have adopted the subjective approach. *E.g.*, Gold v. Sloan, 486 F.2d 340 (4th Cir. 1973), *cert. denied*, ___ U.S. ___, 95 S. Ct. 134 (1974). The Supreme Court has approved the subjective method, Kern County Land Co. v. Occidental Petroleum Corp., 411 U.S. 582 (1973), thereby making the Third Circuit's holding questionable. Several law review articles have examined the reasons behind the objective and subjective approaches. *E.g.*, Bateman, *The Pragmatic Interpretation of Section 16(b) and the Need for Clarification*, 45 ST. JOHNS L. REV. 772 (1971); Weinstock, *Section 16(b) and the Doctrine of Speculative Abuse: How to Succeed in Being Subjective without Really Trying*, 29 BUS. LAW. 1153 (1974).

[49] 411 U.S. 582 (1973). *See, e.g.*, Note, 15 B.C. IND. & COM. L. REV. 149 (1973); Note, *Insider Liability for Short Swing Profits: The Substance and Function of the Pragmatic Approach*, 72 MICH. L. REV. 592 (1974); Note, *Kern County Land Company v. Occidental Petroleum Corporation: An Approach to 16(b)*, 28 SW. L.J. 487 (1974).

[50] 411 U.S. at 593-96.

[51] The case arose out of Occidental's attempted takeover of Kern by a tender offer to Kern's shareholders. The tender offer failed, however, and Kern defensively merged with Tenneco Corporation. To rid itself of the Tenneco stock which it would receive pursuant to the Kern-Tenneco merger agreement exchange, Occidental gave Tenneco an option to purchase the Tenneco shares. The option granted to Tenneco could not be exercised, however, until six months after the exchange of Kern shares for Tenneco. Thus, there was no cash sale in question. 411 U.S. at 584-89. The plaintiff, however, argued that the option agreement or the subsequent exchange of shares pursuant to the merger agreement was a § 16(b) sale which could be matched with the tender offer purchase.

[52] 411 U.S. at 598; Gold v. Sloan, 486 F.2d 340, 343-44 (4th Cir. 1973), *cert. denied*, ___ U.S. ___, 95 S. Ct. 134 (1974).

[53] 411 U.S. at 599, 602. *See* Note, *Securities Exchange Act Section 16(b): Fourth Circuit Harvests Some Kernels of Gold*, 42 FORDHAM L. REV. 852, 869 (1974).

[54] The Court found that the antagonism between Occidental and Kern foreclosed any access by Occidental to inside information of Kern. 411 U.S. 598-99, 601-02. Further, the Court held that neither the exchange of Kern shares for Tenneco nor the option agreement was sufficiently controlled by Occidental to offer possibilities for the type of speculation which § 16(b) was intended to proscribe. 411 U.S. at 599, 601-02.

[55] Although § 16(b) liability attaches automatically to allow the issuing corpora-

whether the test becomes, in essence, a case by case approach which permits an examination of the facts for actual abuse thereby weakening the § 16(b) presumptions in favor of the plaintiff and severely reducing the section's deterrent effect.[56] In the 1974 case *Makofsky v. Ultra Dynamics Corp.*,[57] a district court eschewed any inquiry into the actuality of the defendant's misuse of inside information. Instead, it interpreted the *Kern* test as providing that:

> [T]he principal inquiry in a pragmatic [subjective] analysis is whether the transaction in issue could *possibly* tend to accomplish the practices § 16(b) was designed to prevent . . . . The indices of such a possibility are access to inside information (as distinguished from possession of it), and the ability to influence the timing and circumstances of the transaction in issue.[58]

The facts in the *Makofsky* case were complex,[59] but essentially

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tion to recover all profits resulting from orthodox sales and purchases within the statutory six-month period, it is not always clear what transaction in a series of business events is the orthodox sale or purchase. *E.g.*, Lewis v. Realty Equities Corp., [1973-1974 Transfer Binder] CCH FED. SEC. L. REP. ¶ 94,459 (S.D.N.Y. 1974). Moreover, the difficulties involved in sorting out the legal obligations in such transactions are compounded by the courts' use of a speculative abuse test to determine the date of the orthodox transaction. Booth v. Varian Associates, 334 F.2d 1, 4 (1st Cir. 1964), *cert. denied*, 379 U.S. 961 (1965). Because it is similar to the speculative abuse test used in cases involving unorthodox transactions, the *Booth* test can lead to decisions in which it is not clear whether the court believed the transaction to be orthodox or unorthodox. *See* Champion Homebuilders Co. v. Jeffress, 490 F.2d 611 (6th Cir. 1974).

[56] The *Kern* Court indicated that in situations involving unorthodox transactions, the courts should examine each case on its own facts in deciding if a possibility for abuse existed. *See* Note, *Supreme Court, 1972 Term*, 87 HARV. L. REV. 291, 297-98 (1973). If, however, the courts go so far as to examine each fact situation for actual abuse, the courts could come close to searching for an intent to speculate, an inquiry foreclosed by the statute. *See* Comment, *Non-Cash Exchange Pursuant to a Defensive Merger*, 49 N.Y.U. L. REV. 353, 361-64 (1974). A case by case approach which involves an examination of actual abuse would dilute the deterrent effect of the section. Kern County Land Co. v. Occidental Petroleum Corp., 411 U.S. 582, 612 (1973) (Douglas, J., dissenting). Insiders, believing that they could distinguish the facts of their cases from those involved in past cases in which liability was imposed would be tempted to carry out the transaction and then litigate the question of liability. *See* 2 L. LOSS, SECURITIES REGULATION 1043 (2d ed. 1961); Note, *Securities Exchange Act Section 16(b): Fourth Circuit Harvests Some Kernels of Gold*, 42 FORDHAM L. REV. 852, 859 (1974); Note, 15 B.C. IND. & COM. L. REV. 149, 161-62 (1973).

[57] 383 F. Supp. 631 (S.D.N.Y. 1974).

[58] *Id.* at 638 (emphasis in original) (citation omitted). The *Makofsky* court also put the *Kern* test in the conjunctive; both indices must be met before a transaction will be defined as a purchase or a sale. *Id.* at 640.

[59] Ultra Dynamics acquired shares of Avis Industrial Corporation pursuant to

involved an acquisition of shares by an aggressor corporation followed by a sale within six months. The sale was prompted, however, not by a defensive merger of the target corporation, as in *Kern*,[60] but by the aggressor corporation's inability to finance the purchase. Holding the transaction to be unorthodox,[61] the *Makofsky* court applied its version of the *Kern* test and found that Ultra, the aggressor, had access to inside information of the target Avis Corporation not only because the intercorporate antagonism which had characterized the *Kern* case[62] was absent, but also because Ultra had two designees on the Avis board.[63] Moreover, the court found that Ultra had some control over the sale of Avis stock as well as alternatives to selling, thereby creating the possibility that Ultra could use inside information in selling the stock.[64] Thus both elements of the *Kern* test, access to

three agreements: (1) a purchase of Avis Corporation treasury stock, (2) a purchase of the bulk of the shares of Avis, the majority shareholder, and (3) an option to purchase the rest of Avis' shares at $12 per share. Ultra completed the first two transactions but was unable to raise the money necessary to pay for the shares received. To protect its position, however, Ultra exercised the option and then, still unable to finance the purchases, sold all of its Avis Corporation shares at $16 each. The plaintiff sued under § 16(b) for the difference between the purchase price of the option shares and their sale price. 383 F. Supp. at 634-36.

[60] *See* note 51 *supra*.

[61] 383 F. Supp. at 637.

[62] *See* note 54 *supra*.

[63] 383 F. Supp. at 634. The court held that the designees' knowledge of inside information should be imputed to Ultra. The court did not address the question of whether Ultra had "deputed" these designees. *See* Blau v. Lehman, 368 U.S. 403 (1962) (no "deputing"); Feder v. Martin Marietta Corp., 406 F.2d 260 (2d Cir. 1969) *cert. denied*, 396 U.S. 1036 (1970) ("deputing").

[64] The court analyzed the facts in two stages. First, it found that Ultra was not compelled to purchase the last lot of shares under the option agreement. Unlike the *Kern* defendant, 411 U.S. at 597-98, Ultra was in a position to weigh the alternatives to purchasing because it had access to inside as well as public information. 383 F. Supp. at 641. Second, the *Makofsky* court held that Ultra was not forced to sell the Avis stock. Not only could Ultra have foreseen the possibility that it would not receive the financing which it had expected, Ultra had other alternatives. Moreover, it had some bargaining power in the final agreement which it made to dispose of the Avis stock. The court concluded that Ultra had sufficient control over the circumstances and timing of the sale to meet the *Kern* test. *Id.*

The *Makofsky* court's application of the *Kern* test was broader than the Supreme Court's application of the standard in *Kern*. There was evidence that Occidental had access to some inside information of Kern. Abrams v. Occidental Petroleum Corp., 323 F. Supp. 570, 575 n.3 (S.D.N.Y. 1970), *rev'd*, 450 F.2d 157 (2d Cir.), *aff'd*, 411 U.S. 382 (1974). Moreover, it would seem that Occidental could have waited to grant an option for the Tenneco shares until the six month period had expired. *See* note 51 *supra*. The *Kern* court, however, focused on the terms of the option rather than the alternatives to it. 411 U.S. at 601-02.

inside information and sufficient control over the sale to allow misuse of inside information, were satisfied. In essence, § 16(b) retained much of its mechanical character in *Makofsky*. The court's interpretation of the *Kern* test required an examination of the facts, not to find whether Ultra actually abused its insider position, but rather, to determine if the transaction could have been profitably misused by the corporate insider.

In another recent case involving an attempted merger, *American Standard, Inc. v. Crane Co.*,[65] the Second Circuit was not so automatic in its application of the *Kern* test. The defendant Crane, after unsuccessfully proposing a merger to the management of Westinghouse Air-Brake Company, acquired Air-Brake stock both in the market and by tender offer. Although Air-Brake fought Crane's action and negotiated a defensive merger with American Standard, Crane continued to fight for control of Air-Brake by extending the duration of its tender offer. Crane's plan failed, however, and Air-Brake merged with American Standard. Crane remained only a minority holder of Air-Brake common, and therefore received shares of American Standard preferred pursuant to the merger agreement. Shortly after the merger, Crane sold the preferred shares, prompting Amercan Standard to sue for Crane's profits in its dealings in Air-Brake and American Standard stock.[66]

American Standard argued that three sets of transactions could be considered § 16(b) purchase and sale events. First, Crane's purchases[67] of Air-Brake common could be matched with its disposal of the common in the merger exchange. Second, Crane's acquisition of American Standard preferred pursuant to the merger agreement could be matched with the cash sale of these shares less than six months later. Finally, Crane's purchase of Air-Brake common could be matched with its sale of American Standard preferred.[68] Thus, two questions were posed: could the exchange of Air-Brake common for American Standard preferred be considered either a sale of the common or a purchase of the preferred and, could the purchase of one corporation's stock be matched with the sale of another corporation's securities for § 16(b) purposes.

In resolving both questions, the Second Circuit applied the *Kern* subjective test which it interpreted as requiring an inquiry (1)

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[65] CCH FED. SEC. L. REP. ¶ 94,924 (2d Cir. Dec. 20, 1974).

[66] *Id.* at 97,181-83.

[67] All of Crane's purchases of Air-Brake could be considered § 16(b) purchases because the first purchase made Crane a ten percent owner. *Id.* at 97,181, 97,184.

[68] *Id.* at 97,184.

whether there was likelihood of access by Crane to inside information due to its ownership of more than ten per cent of Air-Brake's common and (2) whether Crane could have controlled the events surrounding the merger.[69] The exchange of Air-Brake common for American Standard preferred, the court concluded, offered no potential for abuse under the *Kern* test due to the antagonism between the managements of Air-Brake and Crane. Crane's inability to control the merger events was shown by its inability to prevent the Air-Brake—American Standard combination.[70] Therefore, the exchange of shares was neither a purchase nor a sale under § 16(b).

Whether Crane's purchases of Air-Brake common prior to the merger could be matched with its post-merger sale of American Standard preferred was a novel question in § 16(b) litigation. The court found that if the section were read literally it would not include such a transaction. The language of § 16(b) refers only to one issuer, thus implying that to be liable, a ten percent owner must have access to inside information of the same issuer at both the purchase and sale.[71] When Crane purchased Air-Brake common, it gained no access, even by statutory presumption,[72] to inside information of American Standard.[73] The court found support for this literal reading of the statute in the legislative history of the section which indicated a congressional intent to prohibit profitable misuse of inside information of the corporation issuing the shares involved. To allow American Standard to recover on the basis of a purchase which made Crane a statutory insider of Air-Brake but not of American Standard would not redress any misuse of American Standard inside information, but would provide a windfall for the suing corporation.[74] Moreover, a holding that a purchase of Air-Brake common could not be matched with a sale of American Standard preferred would probably not remove from the scope of § 16(b) those transactions in which an insider could profitably misuse corporate information.[75] On the other hand, to promote the tender offer method of corporate acquisition would benefit the

[69] *Id.* at 97,187-88.

[70] *Id.* at 97,188. The court did not decide whether American Standard's contention that Crane's chairman had access to inside information of Air-Brake should change its holding; Standard introduced evidence of such access at too late a point in the trial. *Id.* at 97,183, 97,188-89.

[71] *Id.* at 97,190.

[72] Section 16(b) creates the presumption that a ten percent owner has access to inside information. *See* text accompanying note 4 *supra*.

[73] CCH FED. SEC. L. REP. ¶ 94,924, at 97,191.

[74] *Id.* at 97,192-93.

[75] *Id.* at 97,193-94.

stockholders of the target corporation.[76]

American Standard, therefore, in conjunction with *Kern* indicates that a company may attempt a tender offer takeover of another corporation without incurring undue risks of § 16(b) liability. If the aggressor corporation succeeds it may retain the acquired stock to maintain control of the target corporation, thereby avoiding a § 16(b) sale. If the aggressor company fails due to the opposition of the target corporation and its defensive merger with a third company, the defeated aggressor may dispose of the shares within six months of their purchase. Under *Kern*, it may grant an option to sell the stock and, following *American Standard*, it may actually sell the shares. Thus the courts have not actively discouraged tender offer schemes to gain control of corporations.[77]

The tender offer method of corporate acquisition is not entirely free from the risk of § 16(b) liability, however. *Makofsky*[78] demonstrates that if the takeover scheme fails for some reason other than target corporation opposition, the courts may find a possibility of access to inside information and enough potential control over the events surrounding the attempted takeover to impose § 16(b) liability. Similarly, in cases in which the tender offer succeeds, the courts may find opportunities for speculative abuse and allow recovery if the acquiring company disposes of the shares which it purchased within six months of their acquisition.[79] Thus the tender offer purchase of a corporation could present expensive § 16(b) problems for the aggressor company.[80] Moreover, because the subjective approach usually

[76] The tender offer benefits the target corporation shareholders by giving them the choice of selling out of a corporation with which they are dissatisfied at an advantageous price or of remaining in the corporation, which, if the tender offer is successful, may receive new, more progressive management. *Id.* at 97,186-87.

[77] The tender offer appears to be an economically advantageous method for one corporation to acquire another. *See* Comment, *Reliance Electric, Occidental Petroleum, and Section 16(b): Interpretive Quandary over Mergers*, 51 TEX. L. REV. 89, 103-05 (1972).

[78] 383 F. Supp. 631 (S.D.N.Y. 1974). *See* notes 57-64 and accompanying text *supra*.

[79] Newmark v. RKO General, Inc., 425 F.2d 348 (2d Cir.), *cert. denied*, 400 U.S. 854 (1970) (access of parent-aggressor corporation to inside information of target corporation during merger negotiations between subsidiary and target corporations created potential for speculative abuse). *See* text accompanying notes 32-36 *supra*.

[80] Section 16(b) litigation can be expensive not only due to attorney's fees. Most of the courts have adopted an arbitrary "high-low" method of calculating § 16(b) damages. *See, e.g.*, Smolowe v. Delendo Corp., 136 F.2d 231 (2d Cir.), *cert. denied*, 320 U.S. 751 (1943). Thus liability under the section could involve much more than the return of profits as determined by standard accounting methods.