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# Section 16(b) Existentialism: A Journey Towards the Fulfillment of 16(b)'s True Purpose

Avi Strauss

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## ABSTRACT

Section 16(b) of the Securities Exchange Act of 1934 compels an insider to disgorge short-swing profits earned from a paired purchase and sale of the issuer's securities executed within six months. On one hand, Section 16(b)'s introductory purpose clause seems to limit the statute's application to instances where there might be a risk of speculative abuse. On the other hand, Section 16(b) imposes a strict liability-like standard that triggers disgorgement once the statute's objectively applied criteria are met. The circuit courts, in interpreting *Kern County Land Co. v. Occidental Petroleum Corp.*, the seminal Supreme Court decision on the matter, are divided over whether to adopt an objective or subjective approach and, as such, how and when to apply the Supreme Court's unorthodox transaction exemption from 16(b) liability. This Note analyzes the split and offers a critique of the Second Circuit's pragmatic interpretation of *Kern County*'s ruling.

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* J.D. Candidate, Fordham University School of Law, 2013; M.A., Medieval Jewish History, Yeshiva University; B.A., History, Yeshiva College. I would like to express my gratitude to my wife, Sara, and son, Binyamin, for their unwavering love and support throughout law school and, most especially, during the process of drafting this Note. Special thanks as well to my dear mother and in-laws for their unconditional love and for all that they have done to help us navigate our way through graduate school.

## INTRODUCTION

Under Section 16(b) of the Securities Exchange Act of 1934 ("Exchange Act"),[1] short-swing profits earned by a corporate insider from the paired sale and purchase, or purchase and sale, of the issuer's security within a six month period may be disgorged and recovered by the issuer.[2] Section 16(b), passed at the dawn of the New Deal era as a restriction on insider trading, has never been a provision that provided fertile grounds for litigation since its impact always lay more in its deterrent, or prophylactic, effect than in its prosecutorial ambitions.[3]

1. Securities Exchange Act of 1934 § 16(b), 15 U.S.C. § 78p(b) (2006).
2. *Id.*
3. The mechanical, bright line rule for administration of Section 16(b) facilitates the establishment of a strong deterrent effect, while avoiding a taxing amount of litigation. *See* Karl Shumpei Okamoto, *Rereading Section 16(b) of the Securities*

Operating very much under the radar, and under the shadows of Section 10(b) and Rule 10b-5's own insider trading restriction,[4] Section 16(b) has endured the test of time all the same.[5]

Still, in recent years, its efficacy has been challenged, or at least, complicated by a constantly evolving class of "'unorthodox' transactions"[6] and an increasingly complex array of financial instruments, which have threatened to elude classification as Section 16(b) purchases and sales.[7] In the face of these challenges, Section 16(b)'s introductory purpose clause, which self-identifies the statute's underlying rationale, has proven to be both a stabilizing force that has guided courts' application of Section 16(b) and a destabilizing force that has compelled courts to engage in the type of ad hoc, case-specific analysis that defies simple administration of the law.[8] The same adaptations that have ensured Section 16(b)'s durability have accelerated its demise as a prophylactic measure.[9]

This Note focuses primarily on the types of transactions that are subject to Section 16(b) disgorgement and, in particular, how the purpose clause dictates the choices that courts and the Securities and Exchange Commission ("SEC") have made regarding the Section 16(b) eligibility of unorthodox transactions and derivative securities. Since the terms "purchase" and "sale" are meant to be construed in a way that advances the statutory purpose, courts typically subject a transaction to the restrictions of Section 16(b) only if treating the transaction as a "purchase" or "sale" is supportable under the statute and if the transaction could give rise to speculative abuse.[10]

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*Exchange Act*, 27 GA. L. REV. 183, 192 (1992) (citing Newmark v. RKO Gen., Inc., 425 F.2d 348, 351(2d Cir. 1970)).

4. *Id.* at 184.

5. *Id.* at 183–84.

6. This term was coined by Professor Louis Loss, who used it in reference to a group of transactions including "stock conversions, exchanges pursuant to mergers and other corporate reorganizations, stock reclassifications, and dealings in options, rights and warrants." 2 LOUIS LOSS, SECURITIES REGULATION 1069 (2d ed. 1961), *quoted in* Kern Cnty. Land Co. v. Occidental Petroleum Corp., 411 U.S. 582, 593 n.24 (1973).

7. *See* Peter J. Romeo & Alan L. Dye, *Developments Under Section 16*, *in* ALI-ABA COURSE OF STUDY: FUNDAMENTALS OF SECURITIES LAW 598 (2011).

8. *See infra* Parts II and III.

9. *See infra* Parts III and IV.

10. Bershad v. McDonough, 428 F.2d 693, 696 (7th Cir. 1970) ("[C]ourts have generally concluded that a transaction falls within the ambit of Section 16(b) if it can be

Part I of this Note first presents an overview of Section 16(b) of the Exchange Act, including its statutory elements and basic judicial overlay. This Part then examines the statute's preamble, or introductory clause, which explicitly identifies the statute's goal. After considering the standard, Supreme Court-approved understanding of the statutory purpose, this Part presents two scholars' innovative readings of Section 16(b)'s purpose. Challenging the presumption that Section 16(b) was exclusively designed to protect investors from insider trading, these scholars attribute more nuanced and particular motivations to the lawmakers who drafted the Exchange Act.

Part II assesses the early judicial shift, popularized by the Supreme Court's decision in *Kern County Land Co. v. Occidental Petroleum Corp.*,[11] away from a harsh and objective application of Section 16(b) toward a more relaxed, pragmatic, and statutory purpose-driven application. This Part analyzes how, instead of automatically branding all transactions that meet Section 16(b)'s technical criteria as Section 16(b) restricted purchases or sales, courts have developed a methodology of case-by-case analysis, under which a matching purchase and sale can only trigger disgorgement in cases that allow for the possibility of speculative abuse. In particular, Part II explores the Supreme Court-sanctioned unorthodox transaction exception and the varying interpretations of it offered by the circuit courts. It presents a split between the Second Circuit, which interprets the Supreme Court ruling in light of its statutory purpose-driven, subjective approach to Section 16(b), and the Ninth and Fifth Circuits, which read the Supreme Court ruling through the lens of their objective approach to Section 16(b). Finally, Part II demonstrates how the subjective approach shaped the SEC's decision to classify derivative security transactions as Section 16(b) purchases and sales.

Part III takes a critical look at the Second Circuit's statutory purpose-driven reading of the Supreme Court's unorthodox transaction exception. After offering a more nuanced and complex rendering of the Second Circuit position, this Part highlights some of the failures of the Second Circuit view. Ultimately, this analysis leads to the conclusion that the Second Circuit approach necessitates an ad hoc, case-specific

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reasonably characterized as a 'purchase' or 'sale' without doing violence to the language of the statute, and if the transaction is of a kind which can possibly lend itself to the speculation encompassed by Section 16(b).").

11. 411 U.S. 582 (1973).

approach that does not properly serve the prophylactic interests of Section 16(b).

## I. OVERVIEW OF SECTION 16(b)

Part I of this Note first introduces the statutory elements that form the basis of a Section 16(b) claim for disgorgement. Next, it highlights the strict liability-like regime created by the mechanical operation of those elements. Then, it presents a discussion of the underlying rationale behind the statute, as articulated in the statute's introductory clause and interpreted by the courts and by modern day scholars. Part I then addresses the early judicial attempts to reconcile the objective terms of Section 16(b) application with the statutory purpose and illustrates how those early decisions culminated in the seminal Supreme Court decision on the matter. Finally, this Part concludes by examining the confounding factors in *Kern County* that contributed to a circuit split revolving around the scope of *Kern County*'s unorthodox transaction exemption.

### A. SECTION 16(b) STATUTORY ELEMENTS

To establish a Section 16(b) claim for disgorgement, the plaintiff—either the security issuer or one of its shareholders who files suit derivatively[12]—must prove that the defendant—a corporate insider or over-10% shareholder—realized profit from a paired purchase and sale of the issuer's securities within a six month period.[13] The terms "sale"

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12. *See* Securities Exchange Act of 1934 § 16(b), 15 U.S.C. § 78p(b) (2006) ("Suit to recover [short-swing] 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.").

13. *See* Gwozdzinsky v. Zell/Chilmark Fund, L.P., 156 F.3d 305, 308 (2d Cir. 1998). The statute states, in relevant part:

> 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) . . . 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 or security-based swap agreement purchased or of not

and "purchase" are not explicitly defined in Section 16(b) itself, but have been broadly defined elsewhere in the Exchange Act.[14] Under the Act, "[t]he terms 'buy' and 'purchase' include any contract to buy, purchase, or otherwise acquire," while "[t]he terms 'sale' and 'sell' include any contract to sell or otherwise dispose of."[15] These definitions, as applied to Section 16(b), expose a wide range of transactions to liability.[16] In fact, a purchase or sale does not need to be scrutinized under the standard trappings of contract law or commercial law to meet Section 16(b) requirements.[17] Nevertheless, the emergence of so-called "unorthodox transactions" and the rapid growth of the derivative securities market challenged the courts and the SEC to further widen the net of transactions that could be classified as Section 16(b) purchases and sales so as to effectuate the statutory purpose of Section 16(b).[18]

### B. SECTION 16(b)'S MECHANICAL OPERATION

Section 16(b) establishes bright line rules under which an insider's in and out sequence of trades within a six month period creates a presumption of abuse.[19] That is to say that "paired" transactions trigger Section 16(b) liability whether or not the insider intended for them to offset one another as a means of securing speculative profit.[20]

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> repurchasing the security or security-based swap agreement sold for a period exceeding six months.

15 U.S.C. § 78p(b).

14. *See* Securities Exchange Act of 1934 § 3(a)(13)–(14), 15 U.S.C. § 78(c)(a)(13)–(14) (2006).

15. *Id.*

16. Arnold S. Jacobs, *An Analysis of Section 16 of the Securities Exchange Act of 1934*, 32 N.Y.L. SCH. L. REV. 209, 391 (1987).

17. *Id.* (citing, e.g., Portnoy v. Revlon, Inc., 650 F.2d 895, 898 (7th Cir. 1981)). *See also* Bershad v. McDonough, 428 F.2d 693, 697 (7th Cir. 1970).

18. *See infra* Part II.

19. Okamoto, *supra* note 3, at 193 (quoting Kern Cnty. Land Co. v. Occidental Petroleum Corp., 411 U.S. 582, 611 (1973) (Douglas, J., dissenting)).

20. Section 16(b) allows for the disgorgement of insider profits "irrespective of any intention on the part of such beneficial owner, director, or officer in entering into such transaction of holding the security or security-based swap agreement purchased or of not repurchasing the security or security-based swap agreement sold for a period exceeding six months." Securities Exchange Act of 1934 § 16(b), 15 U.S.C. § 78p(b) (2006). An insider can earn a "speculative profit" by "investing in the securities of his

Legislators intentionally crafted Section 16(b) to operate in this mechanical way so as to facilitate practical administration of the rule. Thomas G. Corcoran, advisor to President Franklin D. Roosevelt and one of the drafters of Section 16, famously testified at the legislative hearing on the Exchange Act that:

> [Y]ou hold the director, irrespective of any intention or expectation to sell the security within 6 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.[21]

As a by-product of this strict liability-like regime,[22] which links any two counter-transactions of the insider's company stock, realized profits for Section 16(b) purposes are computed as the difference between the highest sale price and lowest purchase price for which an identical number of the insider's shares were transacted within a six month period.[23] Section 16(b)'s objective standard is also a determining factor in establishing the potential liability of the parties involved. The statute's flat rule, which calls for a presumption of abuse, only applies to corporate insiders and beneficial owners—over-10%-owners of the company's stock.[24] The extension of the law, beyond the typical corporate executive or officer to include an over-10%-beneficial owner as a statutory insider, presumes that such a person exerts enough control

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issuer, holding them briefly, and then divesting himself of his investment at a tidy profit." Newmark v. RKO Gen., Inc., 425 F.2d 348, 355 (2d Cir. 1970).

21. *Hearings on Stock Exchange Practices before the S. Comm. on Banking and Currency*, 73d Cong. 6557 (1934) (testimony of Thomas Corcoran).

22. *See* Gwozdzinsky v. Zell/Chilmark Fund, L.P., 156 F.3d 305, 310 (2d Cir. 1998) ("The statute, as written, establishes strict liability for all transactions that meet its mechanical requirements.").

23. *See* Donoghue v. Natural Microsystems Corp., 198 F. Supp. 2d 487, 492 (S.D.N.Y. 2002). This "lowest purchase price, highest sale price" rule, known as the 'Lowest-In, Highest-Out' method, is considered "w[e]ll-established." Huppe *ex rel.* WCPS Int'l Inc. v. Special Situations Fund, 565 F. Supp. 2d 495, 503 (S.D.N.Y. 2008) (quoting Feder v. Martin Marietta Corp., 406 F.2d 260, 269 (2d Cir. 1969)). The rule was first established by the Second Circuit in *Smolowe v. Delendo Corp.*, 136 F.2d 231 (2d Cir. 1943).

24. 15 U.S.C. § 78p(b).

over the company to be privy to inside information.[25] Even then, the bright line rule establishes that a beneficial owner can only face Section 16(b) liability if he owned over 10% of the stock at the time of both the sale and purchase.[26] In contrast to corporate insiders and statutory insiders, Section 16(b) liability can never attach to outside investors, who become privy to inside information through a tippee.[27]

### C. SECTION 16(b)'S STATUTORY PURPOSE

While it is highly unusual for Congress to articulate a provision's underlying rationale in the language of the statute itself, lawmakers incorporated an introductory clause, or preamble, into the statutory language of Section 16(b) to do just that. The legislative history of Section 16(b) suggests any number of possible reasons that lawmakers may have deemed it necessary in this instance.[28] For one, Congress may have inserted the clause to bolster the constitutionality of Section 16(b),[29] which was somewhat questionable given the statute's broad grant of rulemaking authority to the SEC[30] and Congress's arguable overreach of its regulatory authority beyond the realm of interstate

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25. *See, e.g.*, American Standard, Inc. v. Crane Co., 510 F.2d 1043, 1055 (2d Cir. 1975) ("The 10% holder in the garden variety case is presumed to be 'influential' as a friend of management or in control of some directors.").

26. Section 16(b) states: "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 or security-based swap agreement or a security-based swap involved, or any transaction or transactions which the Commission by rules and regulations may exempt as not comprehended within the purpose of this subsection." Securities Exchange Act of 1934 § 16(b), 15 U.S.C. § 78p(b). *See also* Reliance Elec. Co. v. Emerson Elec. Co., 404 U.S. 418, 423 (1972).

27. Blau v. Lehman, 368 U.S. 403, 411–12 (1962).

28. The interpretations offered here are not the product of mere conjecture, but have been offered by commentators who gleaned them from Section 16(b)'s legislative history. *See* Steve Thel, *The Genius Of Section 16: Regulating The Management Of Publicly Held Companies*, 42 HASTINGS L.J. 391, 481 (1991).

29. *See* Smolowe v. Delendo Corp., 136 F.2d 231, 236 (2d Cir. 1943) ("The legislative custom to insert declarations of purpose as an aid to constitutionality is well known.").

30. Thel, *supra* note 28, at 481–82 (citing LOSS, *supra* note 6, at 547–48). Under the statute, Section 16(b) "shall not be construed to cover any transaction . . . which the Commission by rules and regulations may exempt as not comprehended within the purpose of this subsection." 15 U.S.C. § 78p(b).

commerce.[31] At minimum, the statute's self-declared purpose may have been seen as a necessary check on the SEC's statutorily granted power to exempt securities from Section 16(b)'s clampdown on insider trading.[32] The inclusion of the statutory purpose in the Act would force the SEC to limit the exercise of its exemptive authority in ways consistent with the statutory purpose.[33]

The statute's introductory clause explains that the disgorgement of short swing profits is "[f]or the purpose of preventing the unfair use of information which may have been obtained by [a] beneficial owner, director, or officer by reason of his relationship to the issuer . . . ."[34] The Supreme Court understood from Section 16(b)'s introductory clause that the provision was deemed necessary by Congress to attain the Exchange Act's stated goal of "insur[ing] the maintenance of fair and honest markets."[35] It famously observed that "Congress sought to curb the evils of insider trading [by] . . . taking the profits out of a class of transactions in which the possibility of abuse was believed to be intolerably great."[36] Moreover, the Court noted that the Section 16(b) restriction was directed at an issuer's directors and officers, as well as stockholders with over 10% control, because of the presumption that their positions with the issuer company afforded them access to insider information.[37]

31. Thel, *supra* note 28, at 483–84. According to Thel's theory, the true agenda underlying the statute may have been hidden out of concern that political opponents would object to Congress's regulation of corporations, seeing it as an unconstitutional regulation of intrastate commerce. Attributing Section 16(b)'s purpose to insider trading on the stock market makes it easier to present the law as a regulation of interstate commerce. *Id.* at 483–84.

32. *Id.* at 481.

33. *Id.*

34. Securities Exchange Act of 1934 § 16(b), 15 U.S.C. § 78p(b).

35. Kern Cnty. Land Co. v. Occidental Petroleum Corp., 411 U.S. 582, 591 (1973) (quoting Securities Exchange Act of 1934 § 2, 15 U.S.C. § 78b (2006)). One Second Circuit decision, which had already declared achieving a "fair and honest market" to be the primary purpose of 16(b), described such a market as one that "reflect[s] an evaluation of securities in light of all available and pertinent data." *See* Smolowe v. Delendo Corp., 136 F.2d 231, 235 (2d Cir. 1943).

36. Foremost-McKesson, Inc. v. Provident Sec. Co., 423 U.S. 232, 243 (1976) (quoting Reliance Elec. Co. v. Emerson Elec. Co., 404 U.S. 418, 423 (1972)) (internal quotation marks omitted).

37. *Id.* at 243–44.

Henceforth, lower courts and scholars almost unanimously adopted the Supreme Court's articulation of the statutory purpose as gospel.[38]

Still, despite courts' unanimous view that Section 16(b) was meant to combat the evils of insider trading, a variation in one important detail yields two slightly different court formulations of the statutory purpose.[39] Some courts indicate that the statutory purpose of Section 16(b) is to prevent the unjust enrichment of corporate insiders at the expense of investors who are not privy to the same high-level, privileged information.[40] In other words, the statute protects an insider's trading partner from being taken advantage of by an insider who has superior information by virtue of his or her relationship to the issuer.[41] Generally, then, the law protects the public by leveling the playing field for all investors.

Other courts train Section 16(b)'s focus on protecting outside stockholders from the speculative abuse of insiders.[42] From this perspective, Section 16(b) not only seeks to correct for the systemic problem wrought by an information imbalance favoring insiders, but also to put an end to stock price manipulations that insiders could orchestrate to artificially raise or lower stock prices and guarantee

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38. *See* ARNOLD S. JACOBS, 5A DISCLOSURE AND REMEDIES UNDER THE SECURITIES LAWS § 4:150 n.3 (2012) (listing cases). The Supreme Court considered it "well known" that Congress enacted Section 16(b) to curb insider trading. *Foremost-McKesson*, 423 U.S. at 243 ("The general purpose of Congress in enacting § 16(b) is well known." (citing *Kern County*, 411 U.S. at 591–92; *Reliance Elec.*, 404 U.S. at 422)).

39. Jacobs, *supra* note 16, at 357–58. As early as 1943, the Second Circuit had explicitly articulated the twin goals of Section 16(b) in a similar way. *See Smolowe*, 136 F.2d at 235.

40. *See Foremost-McKesson*, 423 U.S. at 243.

41. Steel Partners II, L.P. v. Bell Indus., Inc., 315 F.3d 120, 123 (2d Cir. 2002); Gwozdzinsky v. Zell/Chilmark Fund, L.P., 156 F.3d 305, 308 (2d Cir. 1998) ("Section 16(b) of the Exchange Act seeks to deter 'insiders,' who are presumed to possess material information about the issuer, from using such information as a basis for purchasing or selling the issuer's equity securities at an advantage over persons with whom they trade."). In fact, in one recent decision, the Second Circuit asserted that Section 16(b)'s purpose is only advanced by its enforcement in cases where an asymmetry of information benefits the insider at the expense of the insider's trading partner. *See* Roth v. Perseus, L.L.C., 522 F.3d 242, 249 (2d Cir. 2008) (holding that the SEC did not exceed its statutorily granted power under Section 16(b) by exempting certain transactions between an insider and the insider's issuer under Rule 16b-3(d)).

42. Jacobs, *supra* note 16, at 357–58. *See, e.g.*, American Standard, Inc. v. Crane Co., 510 F.2d 1043, 1060 (2d Cir. 1975).

themselves a profit on a short term investment in the stock.[43] As such, Section 16(b) protects not only the potential investor community and, more specifically, an insider's unsuspecting trading partner, but it also protects actual stockholders of the security who are not privy to the same high level information and could be victimized by an insider's manipulation of the stock.[44]

Despite the explicit and seemingly incontrovertible statutory language that 16(b) was meant to "prevent the unfair use of information" by corporate insiders, some scholars point to weaknesses and inconsistencies that have eroded their faith in and fidelity to the stated statutory purpose. For one, they observe, Section 16(b) is both overbroad and under-inclusive if its goal is to deter insider trading.[45] Section 16(b)'s strict liability-like enforcement renders the statute overbroad since it restricts insiders who do not necessarily have any insider information.[46] At the same time, it is too narrowly constructed to be able to reach all statutory insiders who possess inside information and trade on that basis.[47] In fact, Section 16(b) only allows for the disgorgement of short swing profits earned by insiders from a sale and purchase executed within six months of one another.[48] It is fair game, under 16(b), therefore, for insiders to buy and sell on the basis of inside information as long as their transactions are spaced out over more than six months.[49] Moreover, these scholars observe, if the goal was really to level the playing field, the narrow construction of Section 16(b) is misguided since it handicaps enforcement of the statute with regard to outsiders who obtain insider information.[50]

In recent years, scholars have advanced alternative theories behind Section 16(b)'s statutory purpose, including some that either disregard or blatantly contradict the statute's self-described purpose.[51] Professor Steve Thel offers perhaps the most novel explanation, plumbing Section

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43. Jacobs, *supra* note 16, at 358–59 (citing Blau v. Lamb, 363 F.2d 507 (2d Cir. 1966)).

44. *See id.*

45. *See* Okamoto, *supra* note 3, at 191–92; Thel, *supra* note 28, at 417.

46. Okamoto, *supra* note 3, at 191; Thel, *supra* note 28, at 417.

47. Okamoto, *supra* note 3, at 191–92; Thel, *supra* note 28, at 417.

48. Okamoto, *supra* note 3, at 191; Thel, *supra* note 28, at 417.

49. Thel, *supra* note 28, at 417–18.

50. *Id.* at 446; Okamoto, *supra* note 3, at 209.

51. *See* Okamoto, *supra* note 3; Thel, *supra* note 28.

16's legislative history to uncover what he believes is the hidden agenda underlying Section 16(b).[52] Thel argues that, while restricting insider trading was certainly a goal of some lawmakers in passing Section 16(b),[53] the true goal of Section 16(b) was to regulate corporate management.[54]

According to Thel's theory, lawmakers were more concerned with ensuring the overall financial well-being of publicly held corporations than with eliminating the insider trading advantage corporate insiders might exploit to line their own pockets.[55] Congress designed Section 16(b) to facilitate corporations' long-term growth and sustainability, and thereby maximize corporate profits and shareholder gains, by aligning the interests of corporate management with the interests of stockholders.[56] Specifically, Section 16(b)'s drafters hoped that requiring corporate insiders to hold onto their issuer company's stock for the long-term would discourage insiders from manipulating the market and artificially driving the stock price up or down long enough for them to manufacture short-swing profits.[57]

Thel hypothesizes that lawmakers sought to hide Section 16(b)'s true agenda of effecting a change in corporate structure, under the guise that 16(b)'s purpose was to curb insider trading.[58] In the drafters' minds, concealment of Section 16(b)'s true purpose may have been a necessary tactic to ensure broad support from lawmakers for the passage of Section 16.[59] Disclosure of Section 16(b)'s genuine purpose was seen as likely to expose the provision to political opposition claims that the government was wrongly imposing its will on corporate America and that the provision was constitutionally objectionable.[60] Attributing

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52. Thel offers a critical analysis of the legislative history of Section 16, generally, and demonstrates that increasing unemployment among the general public was the primary force behind the New Deal securities laws. Recalibrating the corporate structure was seen as a means of ultimately improving the plight of consumers and workers, with not so much of a focus on protecting investors as we tend to think. *Id.* at 410–11. A thorough treatment of the legislative history is beyond the scope of this Note.

53. *Id.* at 453.

54. *Id.* at 405–06.

55. *See id.*

56. *Id.* at 399–400.

57. *Id.* at 433.

58. *Id.* at 483.

59. *Id.*

60. *Id.*

Section 16(b) to insider trading, however, was a much safer option since insider trading was seen as an exploitative practice that most lawmakers were presumably eager to eliminate.[61]

Professor Karl Shumpei Okamoto offers a second, alternative basis for Section 16(b) founded on modern finance economics.[62] The purpose of Section 16(b), argues Okamoto, is to disincentivize insiders from transacting in the issuer's stocks for the sole purpose of manipulating the market and artificially effecting price changes.[63] Under Okamoto's theory, the public assumes that corporate insiders trade based on the inside information at their disposal.[64] Because of that perception, corporate insiders' decisions about whether to buy or sell company stock generally trigger temporary price fluctuations in the marketplace, as investors make the corresponding transactions that they believe will enable them to capitalize on the corporate news presumably being broadcast by an insider's trading patterns.[65] But, if an insider deliberately buys or sells company stock in order to elicit a market reaction, and not because of any corporate news, the false signal it produces affords the insider the opportunity to exploit investors' misreading of the market signal and reap a short-swing profit before the market has a chance to recover.[66] Section 16(b) was meant to counteract abuse of this market power; corporate insiders who manipulate the market for personal gain can no longer trade in and out on a short term basis to reap their ill-gained speculative profits.[67]

Okamoto, much like Thel, minimizes the importance of Section 16(b)'s introductory clause. According to Okamoto, Section 16(b)'s introductory clause is merely a "speech" that expresses the concerns of

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61. *Id.* at 483–84.

62. Okamoto, *supra* note 3, at 183, 198. Professor Okamoto explains that, according to modern finance theory, "the value of a capital asset, such as stock, is a function of such asset's systemic risk and its expected return." *Id.* at 198 (citing, *e.g.*, RICHARD BREALEY & STEWART MYERS, PRINCIPLES OF CORPORATE FINANCE 161–65 (4th ed. 1991).

63. Okamoto, *supra* note 3, at 185.

64. *Id.* at 201.

65. *Id.* at 204.

66. *Id.* at 197.

67. *Id.* at 197–98.

Section 16(b)'s drafters[68] and, most certainly, is not a controlling or dispositive guide to 16(b)'s application; however, as much as Okamoto fancies himself to be "[f]reed from [the preamble's] excessive ambition,"[69] he, as well as Thel, cannot break free from nor deny the courts' repeated attributions of the statute to insider trading.[70] In fact, the courts' renderings of the statutory purpose have played a pivotal role in shaping the contours of Section 16(b) jurisprudence.[71]

### D. Background: Early Split Among the Lower Federal Courts

The relative importance of the statute's purpose clause and the flat rule of Section 16(b) almost immediately became the basis of a split among the lower courts regarding Section 16(b)'s scope.[72] As early as 1943, in *Smolowe v. Delendo Corp.*,[73] the Second Circuit downplayed the interpretive value of Section 16(b)'s preamble[74] and opted to abide by an objective, flat rule application of Section 16(b).[75] Early on, this position, which was also adopted by some other circuit courts, seemed to have become the mainstream Second Circuit view.[76]

The contrary view, ultimately adopted by the majority of courts, found the introductory clause to be an overriding factor that superseded

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68. *Id.* at 208 ("The broad language of the preamble was [nothing but a] a speech, a loose articulation of what was on the minds of some of those who participated in adopting the statute.").

69. *Id*.

70. *See supra* notes 34–38 and accompanying text.

71. *See infra* Part II.

72. *See* Kern Cnty. Land Co. v. Occidental Petroleum Corp., 411 U.S. 582, 594 n.26 (1973).

73. 136 F.2d 231 (2d Cir. 1943).

74. Okamoto, *supra* note 3, at 207. *See* Smolowe v. Delendo Corp., 136 F.2d 231, 236 (2d Cir. 1943) ("The failure to limit the recovery to profits gained from misuse of information justifies the conclusion that the preamble was inserted for other purposes than as a restriction on the scope of the Act.").

75. *See Smolowe*, 136 F.2d at 231. *See also* Park & Tilford, Inc. v. Schulte, 160 F.2d 984 (2d Cir. 1947) (adopting the objective rule approach and holding that a conversion of preferred stock into common stock qualified as a statutory "purchase" that, paired with a subsequent sale, gave rise to 16(b) disgorgement).

76. *See, e.g.*, Heli-Coil Corp. v. Webster, 352 F.2d 156 (3d Cir. 1965); Adler v. Klawans, 267 F.2d 840 (2d Cir. 1959); Park & Tilford, Inc. v. Schulte, 160 F.2d 984 (2d Cir. 1947). It was a decidedly imbalanced split among the circuit courts, as the clear majority view adopted the pragmatic approach. *Id.*

the mechanical application of Section 16(b).[77] In fact, the Second Circuit itself later repudiated its earlier commitment to the objective rule and held, for the first time, in *Blau v. Lamb*,[78] that notwithstanding Section 16(b)'s crude rule of thumb, a court should not apply 16(b) unless it first ascertained that the transaction at hand gave rise to the possibility of speculative abuse.[79] The Second Circuit's change of heart was so complete that it would later note "[t]he judicial tendency, especially in th[e Second Circuit], . . . to interpret Section 16(b) in ways that are most consistent with the legislative purpose."[80] Under this subjective approach, a borderline transaction, which did not clearly fall within the scope of Section 16(b) purchases and sales, could still qualify for 16(b) liability if it could give rise to speculative abuse.[81]

### E. SUPREME COURT'S FIDELITY TO SECTION 16(b)'S INTRODUCTORY CLAUSE

The Supreme Court later weighed in, adopting the subjective, pragmatic approach to Section 16(b).[82] In so doing, it established a template for how the introductory purpose clause should interact with the statutory interpretation of Section 16(b) as a whole. Specifically, it held that any ambiguity in the statute should be resolved in favor of the explanation that most closely adheres to the statutory purpose of curbing insiders' short-swing trading.[83] Liability cannot, however, follow under circumstances that fall short of the criteria specified in Section 16(b), no matter how much a Section 16(b) disgorgement would fulfill the statutory purpose.[84]

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77. Jacobs, *supra* note 16, at 428.
78. 363 F.2d 507 (2d Cir. 1966).
79. Blau v. Lamb, 363 F.2d 507, 518–19 (2d Cir. 1966).
80. Portnoy v. Seligman & Latz, Inc., 516 F. Supp. 1188, 1193 (S.D.N.Y. 1981) (quoting Feder v. Martin Marietta Corp., 406 F.2d 260, 262 (2d Cir. 1969)). *See also* DiLorenzo v. Murphy, 443 F.3d 224, 227 (2d Cir. 2006); Steel Partners II, L.P. v. Bell Indus., Inc., 315 F.3d 120, 124 (2d Cir. 2002).
81. Whittaker v. Whittaker Corp., 639 F.2d 516, 522 (9th Cir. 1981).
82. *See* Kern Cnty. Land Co. v. Occidental Petroleum Corp. 411 U.S. 582 (1973).
83. Reliance Elec. Co. v. Emerson Elec. Co., 404 U.S. 418, 424 (1972).
84. Gwozdzinsky v. Zell/Chilmark Fund, L.P., 156 F.3d 305, 310 (2d Cir. 1998).

In its seminal *Kern County Land Co. v. Occidental Petroleum Corp.* decision,[85] the Supreme Court amplified the introductory clause's role as a dispositive factor and, therefore, shrank Section 16(b)'s sphere of influence.[86] Ultimately, though, the scope of *Kern County*'s impact remained wholly undefined until the lower courts later weighed in on the severability of the Supreme Court's holding from *Kern County*'s specific fact pattern.[87] Since courts were initially divided about whether to extrapolate *Kern County's* holding to other cases or whether to limit *Kern County* to a unique set of facts,[88] it is important to first become familiar with the facts of the case.

Occidental Petroleum Corp. ("Occidental") purchased over 10% of Kern County Land Co. ("Old Kern") common stock and extended a tender offer to purchase more.[89] But Old Kern opted instead to engage in a defensive merger with Tenneco, Inc. ("Tenneco"), under which Tenneco agreed to acquire the company through a newly created corporation called Kern County Land Co. ("New Kern").[90] Pursuant to the merger agreement, Old Kern shareholders were expected to forfeit their shares of Old Kern common stock in exchange for the equivalent number of Tenneco preferred shares.[91]

Occidental, with its takeover attempt thwarted and its stake in Old Kern marginalized, took action to protect its interests.[92] Pending final approval of the Old Kern-Tenneco merger, Occidental reached an agreement with Tenneco granting Tenneco's subsidiary, Tenneco Corp., the option to buy all of Occidental's Old Kern-substituted, Tenneco preferred stock at $105 a share.[93] Although Tenneco Corp. was only authorized to exercise the option more than six months after Occidental's tender offer expired, Occidental and Tenneco executed the option agreement within six months of Occidental's purchase of a more

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85. 411 U.S. 582 (1973). *Kern County* was "the culmination of [a] line of cases, the key decision concerning unorthodox transactions, and the only Supreme Court case treating the issue in any depth." Jacobs, *supra* note 16, at 428.

86. *See infra* notes 96–101 and accompanying text.

87. *See infra* Part II.

88. *See infra* Part II.

89. *Kern Cnty.*, 411 U.S. at 585.

90. *Id.* at 586.

91. *Id.*

92. *Id.* at 587.

93. *Id.*

than 10% stake in Old Kern.[94] Reasoning that Occidental's execution of the option, as well as its Old Kern-for-Tenneco share exchange, were sales that occurred within six months of the purchase that transformed Occidental into an over-10% beneficial owner of Old Kern stock, New Kern sued for the Section 16(b) disgorgement of Occidental's realized profits.[95]

The Supreme Court noted that, while Section 16(b) clearly applied to prototypical cash-for-stock purchases and sales, it was less clear whether the statute similarly included borderline, "unorthodox transactions."[96] Reflecting on prior lower court decisions, the *Kern County* Supreme Court observed that the Section 16(b) fate of a borderline transaction depends upon a court's inquiry into "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 . . . ."[97] The congressional purpose, as articulated in Section 16(b)'s introductory clause, controls whether a transaction qualifies as a matching purchase or sale under the statute.[98]

In offering its unorthodox transaction analysis, the Supreme Court adopted the pragmatic approach, which required it to engage in a case-specific analysis to determine "both from the economics of the transaction and the modus operandi of the insider whether there exist[ed] the possibility of speculative abuse of inside information."[99] In doing so, it rejected the objective approach, previously adopted by some lower courts, which subjected all sale and purchase, or purchase and sale, combinations to Section 16(b), whether or not they offered any potential for speculative abuse.[100] Thus the Supreme Court found that where Section 16(b)'s introductory purpose clause could not justify disgorgement in a specific factual scenario, the typical objective and flat

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94. *Id.* at 587–88.

95. *Id.* at 590.

96. *Id.* at 593–94.

97. *Id.* at 594–95.

98. *Id.* at 595. *See also* Reliance Elec. Co. v. Emerson Elec. Co., 404 U.S. 418, 424 n.4 (1972).

99. *Kern Cnty.*, 411 U.S. at 612 (Douglas, J., dissenting). This characterization was concocted by the dissent as a pejorative assessment, but rather nicely sums up the approach, all the same.

100. *Id.* at 606.

application of Section 16(b) would indeed give way to a more subjective and malleable rule.[101]

Under the unusual circumstances of *Kern County*, Occidental's tender offer and hostile takeover attempt guaranteed that the target company, Old Kern, would not share any inside information with Occidental.[102] The Court reasoned, therefore, that Occidental's over-10% ownership anomalously did not lend itself to the type of speculative abuse that could yield guaranteed, short-swing profits.[103]

The substitution of Tenneco stock for Occidental's Old Kern stock did not qualify as a purchase or sale subject to 16(b) because of the convergence of two factors: the exchange occurred involuntarily and under circumstances which precluded any possibility of inside information being exploited for speculative gain.[104] Moreover, execution of the option agreement did not qualify as a Section 16(b) sale since it did not present Occidental with a sufficient opportunity to turn a speculative profit off of inside information about Old Kern.[105] First, Occidental and Tenneco's divergent interests in making the deal made it unlikely that Occidental would actually be privy to inside information.[106] Second, the option agreement's grant of exclusive control to Tenneco to decide whether or not to exercise the option after six months precluded Occidental from actually engaging in any speculative abuse.[107]

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101. The *Kern County* majority held that the statutory purpose would be best honored by a case-by-case analysis. *See id.* at 594–95 (majority opinion). The dissent, which championed the objective approach, responded by arguing that, in fact "the recognized purpose and aim of the statute are more consistently and protectively to be served if the statute is construed literally and objectively rather than non-literally and subjectively on a case-by-case application." *Id.* at 608 (Douglas, J., dissenting) (quoting Petteys v. Butler, 367 F.2d 528, 538 (9th Cir. 1966) (Blackmun, J., dissenting)).

102. *Id.* at 598 (majority opinion).

103. *Id.* at 596.

104. *Id.* at 600.

105. *Id.* at 601.

106. *Id.*

107. *Id.* at 602–03. The Court offered a number of other reasons as well to explain why the option agreement was not an instrument of speculation. *Id.* at 603. Since those reasons are not applicable to the present discussion or have since been superseded, they will not be addressed in this Note. *See infra* notes 200–205 and accompanying text regarding the current law on the execution and exercise of an option agreement.

### F. BACKGROUND TO CIRCUIT SPLIT

While it is clear that the existence of the "the possibility of speculative abuse of inside information" is the death knell for the Section 16(b) *Kern County* exemption,[108] the exact scope of the exemption is unclear and has been a source of confusion among the lower courts. The district court, in *Portnoy v. Seligman & Latz, Inc.*,[109] shed some light on the confusion left in the wake of *Kern County* by at least identifying the root of the problem. It observed that although *Kern County* identified three different factors—accessibility to inside information, voluntariness, and the possibility of speculative abuse—to consider in a Section 16(b) analysis, it never explained what combination of factors would be necessary for an insider to qualify for a Section 16(b) *Kern County* exemption.[110]

## II. POST-*KERN COUNTY* CONFUSION: DIVERGENT NOTIONS OF FIDELITY TO THE STATUTORY PURPOSE

In the aftermath of the Supreme Court's *Kern County* decision, the courts' strict mechanical application of Section 16(b) to qualifying orthodox transactions continued unabated.[111] As always, the voluntary or involuntary nature of the transaction and the insider's level of access to inside information were of no relevance to courts' Section 16(b) purchase and sale calculations;[112] however, as with regards to unorthodox transactions, a circuit split emerged, with each circuit staking out its respective positions on how courts should interpret and

108. Foremost-McKesson, Inc. v. Provident Sec. Co., 423 U.S. 232, 237 (1976).

109. 516 F. Supp. 1188, 1194 (S.D.N.Y. 1981).

110. *See* Portnoy v. Seligman & Latz, Inc., 516 F. Supp. 1188, 1194 (S.D.N.Y. 1981).

111. *See* Whittaker v. Whittaker Corp., 639 F.2d 516, 522 (9th Cir. 1981) ("[T]he pragmatic approach has not ousted the objective view. Rather, the pragmatic approach is used to determine the boundaries of the statute's definitional scope in borderline situations, especially unorthodox transactions. For garden-variety transactions which cannot be regarded as unorthodox, the pragmatic approach is not applicable.").

112. This was in full accordance with *Kern County*'s own statement that "traditional cash-for-stock transactions that result in a purchase and sale or a sale and purchase within the six-month, statutory period are clearly within the purview of [Section] 16(b) . . . ." *Kern Cnty.*, 411 U.S. at 593.

apply the *Kern County* holding.[113] An overwhelming number of courts have imposed a double requirement, under which both (a) involuntariness and (b) a lack of access to inside information (or an absence of potential for speculative abuse) are necessary conditions to trigger the *Kern County* exemption for a particular transaction.[114] All the same, the circuit courts, based in part on their adoption of either a pragmatic or objective approach, differ on the role that each respective factor plays in the operation and ultimate scope of the *Kern County* exemption.

This Part begins by highlighting the Ninth and Fifth Circuits' basic, objective approach to interpreting *Kern County*. Then, it presents the Second Circuit's application of a subjective, pragmatic approach to *Kern County*. Finally, it closes with coverage of the SEC's adoption of the Second Circuit approach and its applications therein.

### A. NINTH AND FIFTH CIRCUITS: NARROW *KERN COUNTY* READING OVERLAYING AN OBJECTIVE APPROACH

Part II.A highlights the Ninth and Fifth Circuits' objective approach to Section 16(b) application. According to the objective approach, an unorthodox transaction that meets the mechanical criteria of Section 16(b) is automatically subject to Section 16(b)'s trading restrictions and may only earn a reprieve from disgorgement if it falls under an exceedingly narrow construction of the *Kern County* exception.[115] In fact, according to the Ninth and Fifth Circuits, the *Kern County* exception will only apply when the double requirement is met and both involuntariness and lack of access to inside information are established.[116] To test for the double requirement, the Ninth and Fifth

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113. *See infra* Part II.A–B.

114. Jacobs, *supra* note 16, at 433. The factors, access to inside information and possibility of speculative abuse, are really one and the same for the purposes of this analysis.

115. *See* Colan v. Mesa Petroleum Co., 951 F.2d 1512, 1523 (9th Cir. 1991); Texas Int'l Airlines v. Nat'l Airlines, Inc., 714 F.2d 533, 539 (5th Cir. 1983).

116. *Colan*, 951 F.2d at 1522 ("Courts following Kern County have recognized that involuntariness is an important factor in determining whether or not a transaction constitutes a 'sale' or 'purchase' within section 16(b)."). The Ninth Circuit decision references a Fifth Circuit decision, *Texas Int'l Airlines v. Nat'l Airlines, Inc.*, 714 F.2d 533, 540 (5th Cir. 1983), and an Eleventh Circuit decision, *Gund v. First Florida Banks, Inc.*, 726 F.2d 682, 686 (11th Cir. 1984), as post-*Kern County* affirmations that

Circuit courts adopt a two-step inquiry, assessing, first, whether the offsetting transaction at issue is "unorthodox", and, second, whether the transaction affords a defendant the possibility of engaging in speculative abuse of inside information.[117] Under this scheme, involuntariness is a determining factor in the first step.[118] This subsection will proceed by first examining one example of the Ninth Circuit's application of the *Kern County* unorthodox transaction analysis and, second, by offering a parallel analysis of one Fifth Circuit court's application of *Kern County*.

### *1. Ninth Circuit Approach: Colan v. Mesa Petroleum Co.*

In the Ninth Circuit's *Colan v. Mesa Petroleum Co.*,[119] Mesa had purchased a 10% stake in Unocal that it planned to increase by making a tender offer.[120] But, after Unocal rebuffed Mesa's takeover bid, Mesa reversed course and agreed to exchange its Unocal stock for debt securities.[121] Significantly, Mesa's exchange was not involuntary.[122] Mesa negotiated for the resolution and, at most, may have been "coerced" by financial exigency.[123] Accordingly, the *Colan* court characterized the transactions as voluntary, orthodox transactions, subject to Section 16(b).[124] The court's analysis ended after the first step of inquiry since the lack of involuntariness rendered the exchange an orthodox transaction squarely governed by Section 16(b).[125] The court did not, therefore, investigate whether defendants had an opportunity to engage in the speculative abuse of inside information.[126] In its decision, the court did not assign any significance to the listing of unorthodox transaction types in footnote twenty-four of the *Kern County* opinion, all

involuntariness is the second necessary factor of the Section 16(b) unorthodox transaction exemption. *Id.*

117. *See, e.g.*, *Colan*, 951 F.2d at 1523–25; *Texas Int'l Airlines*, 714 F.2d at 539–40.

118. *See Colan*, 951 F.2d at 1523–25; *Texas Int'l Airlines*, 714 F.2d at 540.

119. 951 F.2d 1512 (9th Cir. 1991).

120. *Colan*, 951 F.2d at 1514.

121. *Id.* at 1515.

122. *Id.* at 1522.

123. *Id.*

124. *Id.* (citing Oliff v. Exchange Int'l Corp., 669 F.2d 1162 (7th Cir. 1980); Tyco Laboratories, Inc. v. Cutler-Hammer, Inc., 490 F. Supp. 1 (S.D.N.Y. 1980)).

125. *Id.* at 1525.

126. *Id.*

but dismissing the footnote as unnecessary to the opinion.[127] Instead, the Ninth Circuit's two-step analysis, as applied to the case's unique set of facts, alone determined the orthodoxy of a particular transaction[128]

The Ninth Circuit analysis throttled any impact *Kern County* might have on other, factually dissimilar cases in the circuit.[129] Reading *Kern County* as narrowly as could be, the Ninth Circuit volunteered only that *Kern County's* Section 16(b) exception could be applied to a factually identical case.[130] Nothing less than a factual scenario involving a merger-induced, involuntary exchange of the target company's stock for another company's stock could qualify for the *Kern County* exemption.[131] The *Colan* court observed that, not coincidentally, most of the unorthodox transactions that qualified for *Kern County's* narrow exception were stock exchanges effectuated in the context of a merger.[132]

### *2. Fifth Circuit Approach: Texas International Airlines v. National Airlines, Inc.*

In *Texas International Airlines v. National Airlines, Inc.*,[133] the Fifth Circuit, much like the Ninth Circuit, envisioned the voluntariness factor as an element in the first step determination of a transaction's Section 16(b) orthodoxy, and, more generally, shared the Ninth Circuit's vision of how the two *Kern County* factors would interact with one another to establish a Section 16(b) exception for a particular transaction.[134] In this case, Texas International Airlines ("TI") became a beneficial owner of National Airlines, Inc. ("National") after its holdings crossed the 10% threshold.[135] Then, within six months of that purchase, TI reached an agreement with Pan American World Airways, Inc. ("Pan Am") to sell Pan Am a certain number of National shares at a fixed price.[136] Soon

127. *Id.*
128. *Id.* at 1523–25.
129. *Id.* at 1523.
130. *Id.* at 1523.
131. *Id.*
132. *Id.* (citing, e.g., Heublein, Inc. v. General Cinema Corp., 722 F.2d 29, 31 (2d Cir. 1983); Gold v. Sloan, 486 F.2d 340, 344 (4th Cir. 1973)).
133. Texas Int'l Airlines v. Nat'l Airlines, Inc., 714 F.2d 533 (5th Cir. 1983).
134. *Id.* at 540.
135. *Id.* at 535.
136. *Id.*

thereafter, National and Pan Am entered into a merger agreement, which incorporated the terms of a stock-for-cash exchange of National stock.[137] The Fifth Circuit ultimately held TI liable since there was nothing involuntary about the transaction that could render it unorthodox.[138]

*Texas International Airlines* requires Fifth Circuit courts to honor and abide by the mechanical approach to Section 16(b), unless a case presents a fact pattern that mimics *Kern County*, in which case, the pragmatic approach would indeed apply.[139] So, before ever conducting the pragmatic, subjective test to assess the possibility of speculative abuse, a court would first need to overcome the initial hurdle of branding a *Kern County*-like transaction as unorthodox.[140] According to the Fifth Circuit, the Supreme Court's distinction between orthodox transactions, such as garden variety cash-for-stock transactions, and unorthodox transactions, such as stock-for stock exchanges, does not correlate to any greater or lesser chance of speculative abuse.[141] Instead, the Fifth Circuit opines that, in the view of the Supreme Court, the involuntariness factor determines the orthodoxy of a transaction.[142]

### B. SECOND CIRCUIT: NARROW *KERN COUNTY* READING OVERLAYING A PRAGMATIC APPROACH

Part II.B begins with a presentation of the Second Circuit's subjective, pragmatic approach to Section 16(b)'s operation and a demonstration of how it continues to be relevant even post-*Kern County*. Next, Part II.B presents two Second Circuit cases showing that the Second Circuit's unorthodox transaction analysis is predicated on a two-factor test that screens for both involuntariness and inaccessibility of inside information. Part II.B concludes with the view of a rogue Southern District of New York case that, while adopting the pragmatic

137. *Id.* This was a case where "a defeated tender offeror sold its shares in the target corporation to a company with which the target had entered into a merger agreement." *Colan*, 951 F.2d at 1524.

138. *Texas Int'l Airlines*, 714 F.2d at 540 ("Despite the alleged lack of access to inside information and therefore the possibility of speculative abuse, the volitional character of the exchange is sufficient reason to trigger applicability of the language of section 16(b).").

139. *Id.* at 539.

140. *Id.*

141. *Id.* at 539–40.

142. *Id.* at 540.

approach, dismisses the involuntariness factor and implements a single factor test for its *Kern County* analysis.

The Second Circuit's subjective, pragmatic approach, which predates the Supreme Court's *Kern County* decision,[143] seems to have been integrated even post-*Kern County*. As per the Second Circuit's pre-*Kern County* design, Section 16(b)'s purpose clause operates as something of a gate-keeping provision.[144] The potential for speculative abuse is a "threshold issue" that must be assessed even before an unorthodox transaction's elements are matched to Section 16(b)'s mechanically applied criteria.[145] Even now, a Second Circuit court will always conduct an initial screening of an unorthodox transaction to assess its potential for speculative abuse.[146] If an unorthodox transaction carries "'at least the possibility of' speculative abuse of inside information," a Second Circuit court will immediately apply Section 16(b) and test for the presence of Section 16(b)'s mechanically applied criteria.[147] While Second Circuit cases do not explicate the relationship between its own threshold test and the *Kern County* exemption analysis,[148] it is clear that once the threshold test yields a positive finding for a possibility of speculative abuse, the *Kern County* unorthodox transaction exception would no longer serve as a viable defense for the insider.[149]

### *1. Second Circuit's Two-Factor Kern County Analysis*

In conducting an unorthodox transaction analysis, the Second Circuit, almost uniformly, has adopted a narrow reading of *Kern County*

143. *See* Blau v. Lamb, 363 F.2d 507, 519–20 (2d Cir. 1966) (reversing Second Circuit's earlier application of an objective rule).

144. *See* Portnoy v. Seligman & Latz, Inc., 516 F. Supp. 1188, 1195 (S.D.N.Y. 1981) ("[T]o judge whether section 16(b) means what it says, a court must *first* ask whether the statute, in light of its purpose, should mean what it says.") (emphasis added).

145. *See, e.g.*, Newmark v. RKO Gen., Inc., 425 F.2d 348, 351, 353 (2d Cir. 1970).

146. *Portnoy*, 516 F. Supp. at 1195.

147. *See, e.g.*, Huppe v. WPCS Int'l Inc., 670 F.3d 214, 218–19 (2d Cir. 2012); Analytical Surveys, Inc. v. Tonga Partners, L.P., 684 F.3d 36, 46 (2d Cir. 2012); *Blau*, 363 F.2d at 519.

148. *See, e.g.*, *Huppe*, 670 F.3d at 218–19; Steel Partners II, L.P. v. Bell Indus., Inc., 315 F.3d 120, 129 (2d Cir. 2002); Gwozdzinsky v. Zell/Chilmark Fund, L.P., 156 F.3d 305, 310 (2d Cir. 1998).

149. *See* cases cited *supra* note 147.

that mandates the presence of both *Kern County* factors to warrant a possible exemption from 16(b) disgorgement. In particular, the Second Circuit has insisted on fulfillment of *Kern County*'s "two factors: (1) the unlikelihood of actual access to inside information in an atmosphere of hostility by a party adverse in interest; and (2) the utter inability of the unsuccessful party to control the course of events."[150] In fact, in *American Standard, Inc. v. Crane Co.*,[151] a Second Circuit decision rendered just a few years after *Kern County*, the court immediately subscribed to the dual requirement view.[152]

In *American Standard*, Crane Co. ("Crane") acquired a more than 10% stake in Westinghouse Air Brake Co. ("Air Brake") stock, with the intention of ultimately effecting a merger between the two companies.[153] Air Brake, however, rejected Crane's overtures and negotiated a defensive merger with American Standard Inc. ("Standard").[154] Under the deal, Air Brake shareholders, such as Crane, would receive a certain amount of Standard shares in exchange for their outstanding Brake shares.[155] As the merger agreement dictated, Crane exchanged its Brake shares for Standard shares; a few days later, Crane sold off its newly acquired Standard shares for a substantial profit.[156] Standard filed suit, alleging that Crane violated Section 16(b) by purchasing and selling the issuer's stocks within a six month period, thereby exploiting the inside information it was privy to in order to earn short swing profits.[157] The Second Circuit, however, rejected Standard's claims, in part, by comparing Crane, the defeated tender offeror in *American Standard*, to Occidental, the defeated tender offeror in *Kern County*.[158] Even though Crane was a 10% stockholder, typically presumed to be an insider, no such presumption could be afforded in this defensive merger context

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150. American Standard, Inc. v. Crane Co., 510 F.2d 1043, 1054 (2d Cir. 1975).

151. 510 F.2d 1043 (2d Cir. 1975).

152. *Id.* at 1053. Ironically, *American Standard* described the defensive merger context in *Kern County* to be "sui generis," intimating, much like the Ninth and Fifth Circuits later held, that the Kern County exception might be exceedingly limited. *Id.* Subsequent Second Circuit decisions did not take such a restrictive approach, however.

153. *Id.* at 1047.

154. *Id.*

155. *Id.* at 1048.

156. *Id.* at 1049.

157. *Id.* at 1051. The Court presented three alternative theories as to which two transactions qualified for the matching purchase and sale. *See id.*

158. *Id.* at 1053–55.

where the underlying hostilities between Standard and Crane all but guaranteed there would be no exchange of confidential information.[159] Moreover, Crane's failure to prevent the unwanted merger from taking place was itself proof that Crane did not exert much control over the target company's directors or stockholders.[160]

Subsequent Second Circuit decisions have adhered to *American Standard*'s dual requirement view, confirming that the *Kern County* exemption only applies to (1) an involuntary transaction (2) conducted by a beneficial owner who lacks access to inside information.[161] Moreover, since *American Standard*, the Second Circuit has continued to subscribe to its particular view of how the two *Kern County* factors interact. The Second Circuit's decision in *At Home Corp. v. Cox Communications, Inc.*[162] brings the Second Circuit's application of the *Kern County* dual requirement into clear view. In *At Home*, Comcast, a 10% beneficial owner of At Home Corp., reached an agreement with AT&T to buy puts, or the right to sell shares, in At Home Corp.[163] Around the same time, Comcast purchased three cable companies, which already owned warrants in At Home Corp.[164] Finally, Comcast proceeded to exercise the puts it had purchased from AT&T.[165]

In assessing potential 16(b) liability in *At Home*, the district court framed the issue as a matter of whether a matching purchase occurs when an insider (Comcast) acquires a third-party company that holds stock in the corporate issuer (At Home Corp.) and, in effect, indirectly purchases the issuer's stock.[166] The district court applied the *Kern County* unorthodox transaction analysis and found that the transaction did not qualify as a Section 16(b) purchase since it did not elicit any concerns of speculative abuse.[167] The Second Circuit, however,

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159. *Id.* at 1062 ("The enemy of yesterday is not the friendly insider of tomorrow.").
160. *Id.* at 1055.
161. Huppe v. WPCS Int'l Inc., 670 F.3d 214, 218–19 (2d Cir. 2012); Analytical Surveys, Inc. v. Tonga Partners, L.P., 684 F.3d 36, 45 (2d Cir. 2012); At Home Corp. v. Cox Commc'ns, Inc., 446 F.3d 403, 408 (2d Cir. 2006).
162. 446 F.3d 403 (2d Cir. 2006).
163. At Home Corp. v. Cox Commc'ns, Inc., 340 F. Supp. 2d 404, 405 (S.D.N.Y. 2004).
164. *Id.*
165. *Id.*
166. *Id.* at 410.
167. *Id.* at 411.

resoundingly rejected the district court's analysis, since the two prerequisites for *Kern County* analysis were not met.[168]

According to the Second Circuit, *Kern County*'s unorthodox transaction analysis does not apply to an insider transaction simply because it may take effect via a newly conceived financial instrument.[169] Rather, the *Kern County* analysis will only yield an effective defense for the insider if both the insider and the transaction are found to be "atypical."[170] In *Kern County*, the insider was atypical since it passed the two-factor test; it did not have access to insider knowledge and it sold its shares involuntarily.[171] In *At Home*, however, where the two *Kern County* criteria were not both met, the insider was typical; no matter how novel or atypical the transaction may have been, the court could not apply the unorthodox transaction analysis.[172]

If the *Kern County* exception analysis fails, as it often does in the Second Circuit, the Second Circuit still offers a simple, direct route towards Section 16(b) exemption that bypasses the more treacherous route paved by *Kern County*.[173] As per its methodology of interpreting Section 16(b) in line with the statutory purpose,[174] the Second Circuit will construe Section 16(b) narrowly when necessary to prevent its harsh application.[175] In fact, in *At Home*, where it was unlikely that a company takeover would have been initiated just to reap short-term, speculative profits, the Second Circuit ultimately exempted the transaction from Section 16(b) liability by offering a statutory justification.[176] The court inferred from the singular form of the

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168. At Home Corp. v. Cox Commc'ns, 446 F.3d 403, 408 (2d Cir. 2006).

169. *Id.*

170. *Id.*

171. *Id.* This characterization is somewhat difficult to reconcile with the more logical and straightforward formulation that would treat the insider as atypical given its lack of access and the transaction as atypical in light of its involuntary nature.

172. *Id.* In two recent cases, the Second Circuit similarly refused to apply the unorthodox transaction exception where both *Kern County* criteria were not met. *See* Huppe v. WPCS Int'l Inc., 670 F.3d 214 (2d Cir. 2012); Analytical Surveys, Inc. v. Tonga Partners, L.P., 684 F.3d 36 (2d Cir. 2012).

173. *See, e.g.*, *At Home Corp.*, 446 F.3d at 408–10.

174. Portnoy v. Seligman & Latz, Inc., 516 F. Supp. 1188, 1193 (S.D.N.Y. 1981) (quoting Feder v. Martin Marietta Corp., 406 F.2d 260, 262 (2d Cir. 1969)).

175. *See, e.g.*, *At Home Corp.*, 446 F.3d at 408–10.

176. *Id.* at 409. Given the disproportionate resources necessary to effect an acquisition of a company and the entirely separate set of risks and opportunities

statutory terms, "equity security" and "such issuer," that 16(b) liability could only attach where each transaction in a matching pair involved the equity securities of the same company.[177]

### *2. Minority Southern District Court View Rejecting the Involuntariness Factor*

Part II.B.2 presents a minority court view that rejects *Kern County*'s involuntariness factor as a necessary criterion for Section 16(b) disgorgement. While this view is largely discredited in the Second Circuit, it highlights the ambiguity in *Kern County*'s presentation of the governing factors for its unorthodox transaction analysis. This subsection proceeds by analyzing the representative case on point.

A minority view among the lower courts recognizes the dual elements invoked in *Kern County*, but refuses to characterize them both as necessary criteria for Section 16(b) disgorgement.[178] In one Southern District of New York case, *Portnoy v. Seligman & Latz, Inc.*,[179] for example, the court adopted a single factor standard, whereby the plaintiff would only need to "show more than . . . a speculative potential for speculative abuse of inside information."[180] In doing so, the court brushed aside involuntariness and all but branded it an irrelevant factor in establishing a *Kern County* exemption.[181] In fact, it refused to recognize Occidental's sale of Tenneco shares in *Kern County* as having been truly involuntary in the first place since Occidental, to the very end, "was given a choice, not an ultimatum, to withdraw its investment, plus a handsome profit, after losing the merger battle."[182]

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presented therein, the Second Circuit compared the likelihood of an insider purchasing a company to reap speculative profits to an investor "speculating in tractors by buying a farm." *Id.* at 409. Nevertheless, the court conceded that a case-specific analysis was necessary to reach its decision in this case since it was still possible that, under different conditions, where the target company was a shell company that only held the issuer's securities, an insider could have incentive to purchase the company solely to purchase its security holdings. *Id.* at 409–10.

177. *Id.* at 408–09.

178. *See, e.g.*, *Portnoy*, 516 F. Supp. at 1198; Freedman v. Barrow, 427 F. Supp. 1129, 1148 (S.D.N.Y. 1976).

179. 516 F. Supp. 1188.

180. *Id.* at 1200.

181. *Id.* at 1198.

182. *Id.*

In *Portnoy*, defendant corporate insiders at Seligman & Latz sold their personally-owned warrants in the company stock to a number of underwriters.[183] The underwriters subsequently exercised the warrants so that they could include the underlying stock in the public offering of Seligman & Latz stock.[184] The insiders, meanwhile, earned a tidy profit from their sale of the warrants to the underwriters.[185] Plaintiffs, filing suit under Section 16(b), demanded disgorgement of those profits on the theory that the underwriters essentially acted as the insiders' agents, remotely allowing the insiders to purchase company stock through the underwriters' exercise of the stock and, within six months, to sell the stocks at a profit through the public offering.[186]

*Portnoy*, however, dismissed any claims of an agency relationship.[187] Moreover, it held that the exercise of the warrants did not constitute a statutory Section 16(b) purchase that could be paired with the defendants' initial sale of the warrants.[188] Since the contract between the insiders and the underwriters fixed the warrants' exercise price from the outset, the warrants' exercise was nearly immune from speculative abuse.[189] Even though the insiders' sale of the warrants was wholly voluntary, it did not matter; the lack of potential for speculative abuse alone dictated that Section 16(b) would not apply.[190]

### C. SEC POSTSCRIPT: ADOPTION OF SECOND CIRCUIT'S PRAGMATIC APPROACH & RESULTING INCLUSION OF DERIVATIVE SECURITIES AS 16(b) PURCHASES & SALES

Since Section 16(b)'s inception, it was always clear that an insider's matching purchase and sale, or sale and purchase, of the corporate issuer's equity securities was subject to Section 16(b) regulation, but courts were split on whether Section 16(b) also applied to more complex financial instruments involving derivative securities. The Second Circuit, for one, generally maintained that transactions in

183. *Id.* at 1189.
184. *Id.*
185. *Id.*
186. *Id.* at 1189–90.
187. *Id.* at 1196.
188. *Id.* at 1195–96.
189. *Id.* at 1195.
190. *Id.* at 1198.

derivative securities could qualify as Section 16(b) purchases and sales.[191] The Second Circuit, therefore, applied Section 16(b) to transactions in derivative securities no differently than to equity securities, as long as there was at least the possibility of speculative abuse of inside information.[192] Other courts, however, were less willing to expand the Section 16(b) zone of bona fide purchases and sales to include transactions in derivative securities.[193] This uneven application of Section 16(b) to derivative securities, whose use had become increasingly popular, posed a challenge to the effective administration of Section 16(b).[194]

The purpose of Section 16(b) remained front and center and, in fact, seems to have been the driving force behind the SEC's amendment to include the purchase and sale of derivative securities as Section 16(b) matching transactions.[195] Specifically, in its 1991 amendments, the SEC sought to stop investors from transacting in derivatives, rather than in the underlying equity securities, as a means of circumventing liability under Section 16(b).[196] The SEC could effectively step in to close the loophole since it was afforded special statutory authority under Section 16(b), which explicitly carved out an exception for "any transaction . . . which the Commission by rules and regulations may exempt as not

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191. *See* Analytical Surveys, Inc. v. Tonga Partners, L.P., 684 F.3d 36, 43 (2d Cir. 2012) (quoting Huppe v. WPCS Int'l Inc., 670 F.3d 214, 218 (2d Cir. 2012)); Blau v. Lamb, 363 F.2d 507, 516 (2d Cir. 1966). The Second Circuit's position was crystallized by its 1966 decision in *Blau*, 363 F.2d 507, and stands in contrast with some of its earlier decisions. *See, e.g.*, Silverman v. Landa, 306 F.2d 422 (2d Cir. 1962); Blau v. Ogsbury, 210 F.2d 426 (2d Cir. 1954).

192. *See Huppe*, 670 F.3d at 218–19; *Analytical Surveys, Inc.*, 684 F.3d at 43, 46; *Blau*, 363 F.2d at 516.

193. *See* Ownership Reports and Trading by Officers, Directors and Principal Security Holders, Securities Exchange Act Release No. 28,869, 56 Fed. Reg. 7242, 7249 n.107 (Feb. 21, 1991) (citing Colan v. Monumental Corp., 713 F.2d 330 (7th Cir. 1983); Morales v. Mapco, 541 F.2d 233 (10th Cir. 1976); *Silverman*, 306 F.2d 422; *Ogsbury*, 210 F.2d 426).

194. *See* Ownership Reports and Trading by Officers, Directors and Principal Security Holders, Securities Exchange Act Release No. 28,869, 56 Fed. Reg. at 7248.

195. *Id.* ("Given the uncertainty surrounding the application of Section 16 to derivative securities under the former rules and existing case law, the Commission is adopting a comprehensive regulatory framework, in order to effect the purposes of section 16 and to address the proliferation of derivative securities and the popularity of exchange-traded options.").

196. Magma Power Co. v. Dow Chem. Co., 136 F.3d 316, 323 (2d Cir. 1998).

comprehended within the purpose of this subsection."[197] Since rules promulgated by the SEC are entitled to deference,[198] courts have generally treated them as good law.[199]

As per the 1991 amendments issued by the SEC, Section 16(b) now applies to the sale and purchase of derivative securities,[200] including "any option, warrant, convertible security, stock appreciation right, or similar right with an exercise or conversion privilege related to an equity security . . . ."[201] In the words of Rule 16b-6(a), "[t]he establishment of or increase in a call equivalent position . . . or put equivalent position" is equivalent to a Section 16(b) purchase or sale of the underlying security.[202] Given that framework, a derivative security transaction could be paired with either an offsetting derivative security transaction

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197. Securities Exchange Act of 1934 § 16(b), 15 U.S.C. § 78p(b) (2006). Technically speaking, the SEC exceeded the bounds of its statutory right to *exempt* transactions by drafting regulations meant to *include* the class of derivative securities under Section 16(b). While the Third Circuit stated that "[t]he Securities Exchange Act of 1934 authorizes the SEC to enact regulations defining which transactions are included in the ban on short-swing trading," Morrison v. Madison Dearborn Capital Partners III L.P., 463 F.3d 312, 314 (3d Cir. 2006), a narrow reading of the statute would suggest otherwise.

198. *See* Chevron, U.S.A., Inc. v. Natural Res. Def. Council, Inc., 467 U.S. 837, 843–44 (1984).

199. *See, e.g.*, At Home Corp. v. Cox Commc'ns, Inc., 446 F.3d 403, 407 (2d Cir. 2006); Roth v. Perseus, L.L.C., 522 F.3d 242, 249 (2d Cir. 2008).

200. Derivative securities are "financial instruments that derive their value (hence the name) from an underlying security or index." *Magma Power*, 136 F.3d at 321. Equity securities, on the other hand, are actual stocks, or similar securities. Securities Exchange Act of 1934 § 3(a)(11), 15 U.S.C. § 78c(11) (2006).

201. 17 C.F.R. § 240.16a-1(c) (2012). Transactions conducted in some of these financial instruments were previously termed "unorthodox transactions" by Professor Louis Loss, and the Supreme Court seems to have vouched for Loss's understanding in its infamously ambiguous *Kern County* footnote. *See infra* note 214 and accompanying text.

202. 17 C.F.R. § 240.16b-6(a) (2012).

> An option . . . is a purchased right to buy or sell property at a fixed or floating price . . . . A call option gives the option holder the right to buy shares of an underlying security at a particular price; thus, a call equivalent position is a derivative security position that increases in value as the value of the underlying equity increases . . . . A put option is the right to sell a security at a specified price; thus, the value of a put option increases as the price of the underlying security falls. A put equivalent position . . . increases in value as the value of the underlying equity security decreases.

*Magma Power*, 136 F.3d at 321 n.2 (2d Cir. 1998) (citations omitted).

or a transaction in the underlying security in order to trigger disgorgement.[203] The amendments drastically changed the Section 16(b) prospects of "unorthodox transactions" in derivative securities, which were not uniformly treated as 16(b) purchases or sales up until that point.[204] The SEC's inclusion of derivative security instruments under Section 16(b) exposed all transactions in derivative securities to 16(b) disgorgement.[205] At the same time, the typical rules for excepting unorthodox transactions became applicable to the many derivative security instruments that were so classified.

## III. CRITIQUE OF THE SECOND CIRCUIT'S PRAGMATIC *KERN COUNTY* ANALYSIS

The most natural approach to Section 16(b), from a statutory perspective, requires implementation of the Ninth and Fifth Circuit objective approach. After all, Section 16(b)'s mechanical criteria set the tone for the objective, strict liability-like approach by compelling disgorgement of short-swing profits regardless of the insider's intent and irrespective of whether the insider actually misused inside information for personal gain.[206] The introductory purpose clause can be dismissed as a mere statement of constitutional justification that should not dictate the operation of 16(b).[207] Therefore, the pragmatic approach, which infuses 16(b)'s introductory purpose clause with greater operational leeway than it grants its crude rule of thumb, must incorporate some semblance of the objective approach into its scheme. The Second Circuit's uneasy marriage of the objective and subjective approaches highlights the inherent weakness in its position and necessarily limits its application.

Part III identifies and analyzes some curiosities and inconsistencies in the Second Circuit approach that may best reflect or even seek to

203. *See* Ownership Reports and Trading by Officers, Directors and Principal Security Holders, Securities Exchange Act Release No. 28,869, 56 Fed. Reg. 7242, 7251 (Feb. 21, 1991).

204. *Id.* at 7249 ("Unlike the results under prior Commission rules and case law, under the rules adopted today, transactions in the derivative securities are matchable against transactions in the underlying securities and against each other.").

205. *Id.* ("[S]hort-swing profits obtained through use of derivative securities are recoverable.").

206. *See* Securities Exchange Act of 1934 §16(b), 15 U.S.C. § 78p(b) (2006).

207. *See supra* notes 28–33 and accompanying text.

compensate for the tension inherent in adopting a pragmatic test in the face of the statute's objective overtones. This Part begins by unpacking the seemingly overlapping Second Circuit and Supreme Court standards that the Second Circuit consistently invokes. Then, it proceeds to offer an explanation for the redundancy in light of the objective-subjective conundrum. In doing so, it highlights how the Second Circuit's pragmatic approach unsuccessfully incorporates some measure of objectivity into its *Kern County* test so as to comply with Section 16(b)'s clear statutory mandate for an objective test. Second, this Part critically examines the Second Circuit's reading of *Kern County*'s unorthodox transaction exemption as a two-factor test and suggests that the formal, element-based criteria offer a concession of sorts to the objective approach. It concludes that the Second Circuit fails to protect the prophylactic quality of Section 16(b), as only a fully objective approach can effectively do.

#### 1. OVERLAPPING *KERN COUNTY* AND SECOND CIRCUIT TESTS

The Second Circuit approach is largely rooted in *Blau v. Lamb,*[208] a pre-*Kern County* decision in which the Second Circuit subjected a transaction involving the conversion of securities to Section 16(b) liability. There, the court unequivocally stated that stock conversions, like all other acquisitions and dispositions of equity securities, would qualify as purchases and sales under the broad definitions of the terms in the Exchange Act.[209] However, the court hedged, qualifying that a particular transaction's classification as a Section 16(b) sale or purchase would hinge on application of a pragmatic test assessing whether the transaction afforded the insider any opportunity to unfairly trade on inside information.[210] Technically, the court was saying that it would not necessarily compel disgorgement from a transaction that met all the mechanical criteria of 16(b).[211] This statutory scheme was devised and applied specifically to blunt the harshness of Section 16(b)'s otherwise objective, strict liability-like mandate.[212]

208. Blau v. Lamb, 363 F.2d 507 (1966).
209. *Id.* at 516.
210. *Id.* at 518.
211. *Id.* at 519.
212. *Id.*

The Supreme Court's *Kern County* ruling accredited the lower courts' category of borderline, or unorthodox transactions to be used in reference to transactions that could not justifiably merit consideration as a purchase or sale even under the broad, liberal meanings of the terms.[213] In footnote twenty-four, the Supreme Court identified unorthodox transactions as including derivative securities such as "stock conversions, exchanges pursuant to mergers and other corporate reorganizations, stock reclassifications, and dealings in options, rights and warrants."[214] In ruling on their Section 16(b) eligibility, the Supreme Court invoked the very standard adopted by *Blau*.[215] In other words, it held that unorthodox transactions qualify as bona-fide Section 16(b) purchases and sales if they give rise to the possibility of speculative abuse.[216] The Supreme Court then proceeded in ad hoc fashion to determine whether the transaction at issue did, in fact, give rise to speculative abuse, as required under *Blau*'s pragmatic test.[217] In so doing, it paid particular attention to the factors of involuntariness and lack of access to inside information.[218] All the same, this litmus test did not express itself as a formal rule.[219] The ad hoc confluence of the factors ultimately gave rise to the confusion that enveloped the lower circuit courts.[220]

But, even after the Supreme Court's *Kern County* ruling, Second Circuit decisions continued to muddle the waters by citing *Blau*'s threshold test in the context of the *Kern County* test.[221] Neither the Supreme Court, nor any subsequent Second Circuit decisions map out exactly how the two work in tandem.[222] It is unclear, for example, whether the *Blau* test is meant as a first-step inquiry, to be followed by the *Kern County* test if no possibility of speculative abuse is found

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213. Kern Cnty. Land Co. v. Occidental Petroleum Corp., 411 U.S. 582, 593–94 (1973).

214. *Kern Cnty.*, 411 U.S. at 593 n.24 (citing LOSS, *supra* note 6, at 1069). *See* Jacobs, *supra* note 16, at 403.

215. *Kern Cnty.*, 411 U.S. at 595.

216. *Id.*

217. *Id.* at 595–604.

218. *Id.*

219. *See supra* notes 108–10 and accompanying text.

220. *See supra* Part II.

221. *See, e.g.*, Huppe v. WPCS Int'l Inc., 670 F.3d 214, 218–19 (2d Cir. 2012); Steel Partners II, L.P. v. Bell Indus., Inc., 315 F.3d 120, 129 (2d Cir. 2002); Gwozdzinsky v. Zell/Chilmark Fund, L.P., 156 F.3d 305, 310 (2d Cir. 1998).

222. *See, e.g.*, cases cited *supra* note 221.

initially, or whether the two ultimately overlap. However, the simplest understanding would seem to be that the *Kern County* two-factor test provides the substance to *Blau*'s "possibility of speculative abuse" form. *Kern County*'s contribution, according to the Second Circuit, would be that it designed a two-factor test for involuntariness and inaccessibility to inside information that would be determinative of whether a given transaction lent itself to the possibility of speculative abuse.

The Second Circuit may have continued to cite to *Blau*, even after *Kern County*, in order to display some modicum of fidelity to the explicitly objective properties of Section 16(b). After all, *Blau*'s speculative abuse test is formulated not as an independent assessment of a transaction's faculty for speculation, but as an initial inquiry to determine whether or not a transaction is formally a "purchase" or a "sale."[223] If *Kern County*'s two-factor test is, in fact, an explication of the Second Circuit's speculative abuse test, this would mean that an insider's voluntariness in conducting a transaction and potential to access inside information would determine a transaction's merits for "purchase" or "sale" classification. By treating these factors as criteria in the statutory definition of a "purchase" and "sale," the Second Circuit, at least, gives off an impression of fidelity to Section 16(b)'s formalistic and objective statutory elements. As such, it injects an element of certainty and predictability into an ad hoc analysis that already strains the prophylactic quality of Section 16(b).[224] Other Second Circuit courts have similarly characterized the possibility of speculative abuse test as a predicate to identifying a transaction as a "purchase" or "sale," presumably as a concession to 16(b)'s standard of objectivity.[225]

However, the Second Circuit's valiant effort to infuse its *Blau* pragmatic approach with a dose of statutory objectivity does not pass muster. The Second Circuit's bundling of involuntariness and inaccessibility as necessary elements in the classification of a statutory 16(b) purchase or sale seems counterintuitive. It stands to reason

223. Blau v. Lamb, 363 F.2d 507, 518 (1966).

224. *See* Kern Cnty. Land Co. v. Occidental Petroleum Corp., 411 U.S. 582, 612 (1973) (Douglas, J., dissenting) (arguing that majority harms Section 16(b)'s prophylactic quality by employing ad hoc analysis for transactions that meet 16(b)'s mechanical criteria).

225. *See, e.g.*, *Steel Partners*, 315 F.3d 120; Reliance Elec. Co. v. Emerson Elec. Co., 404 U.S. 418, 432 (1972).

instead that involuntariness should dictate whether the insider actually conducted a sale or purchase, while inaccessibility to inside information should determine whether there was a possibility of speculative abuse. In fact, this is exactly how the Ninth and Fifth Circuits understood the dynamic between the two factors in *Kern County*'s unorthodox transaction analysis.[226] Moreover, *Kern County*'s explicit, side-by-side pairing of involuntariness and lack of the possibility of speculative abuse as prerequisites for initiating the unorthodox transaction analysis[227] proves the Second Circuit's treatment of involuntariness as a factor in establishing the absence of a possibility of speculative abuse[228] cannot be accurate.

### 2. SECOND CIRCUIT READING OF *KERN COUNTY* AS A FORMAL, TWO-FACTOR TEST

The Second Circuit's insistence on both involuntariness and inaccessibility to inside information as elements of a formal test for the possibility of speculative abuse can be similarly understood as an ode to the objectivity of Section 16(b)'s statutory language. It is true that a close reading of *Kern County* may support the Second Circuit's dual requirement approach and that most lower courts have subscribed to that view.[229] Nevertheless, the need for both criteria is suspect, as scholar Arnold S. Jacobs observes.[230] Jacobs argues it is superfluous to require fulfillment of both factors if the purpose is simply to prevent insider trading; one or the other would suffice for that purpose.[231]

Strictly speaking, Jacobs may be right; but the double requirement can be justified if seen as essentially a hybrid, subjective-objective test. In fact, this may be ideal under the Second Circuit's subjective approach, which tailors the application of Section 16(b) to transactions that violate the statutory purpose. By giving some definite form to its *Kern County* analysis, the Second Circuit curtails some of the unpredictability that its pragmatic approach engenders, and restores

226. *See supra* notes 115–18 and accompanying text.
227. *Kern Cnty.*, 411 U.S. at 600.
228. *See id.* ("[T]he 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 to transactions such as this one.").
229. Jacobs, *supra* note 16, at 433–34.
230. *Id.*
231. *Id.*

some level of deterrence to the application of Section 16(b), which was, a priori, devised for its prophylactic quality. Moreover, practically speaking, the imposition of *Kern County*'s two-factor test on *Blau*'s pragmatic test severely shrinks the number of cases that would come out differently under the objective and subjective approaches. Under this scheme, an objective approach effectively applies anyway, unless an insider, who has access to inside information, conducts a voluntary transaction.

## CONCLUSION

The drafters of Section 16(b) likely never intended for the introductory purpose clause to play a decisive role in Section 16(b)'s application.[232] On the contrary, they envisioned an objective, mechanical operation of Section 16(b) that could trigger disgorgement of an insider's ill-gained profits as long as the statutory elements of Section 16(b) were present.[233] Under that strict liability-like approach, the law imposed liability even if the defendant insider never intended to earn a speculative profit from his or her inside knowledge and even if the defendant insider never actually possessed inside information that he or she could exploit for personal gain.[234]

The flat rule further stipulated that insiders who managed to evade Section 16(b)'s reach by spacing offsetting transactions six months and one day apart were perfectly within their rights to do so.[235] As the Court in *Kern County* famously declared, Congress "sought to curb the evils of insider trading [by] taking the profits out of a class of transactions in which the possibility of abuse was believed to be intolerably great."[236] The prophylactic rule was only realistically expected to prevent instances where the possibility of abuse was intolerably great, but had no illusion of completely eliminating the evil of insider trading. As a prophylactic rule, Section 16(b) was carefully crafted to simplify implementation of the rule and keep the costs of administration down.[237]

232. *See supra* Part I.C.
233. *See supra* Part I.B.
234. *See supra* Part I.B.
235. *See supra* notes 47–49 and accompanying text.
236. Foremost-McKesson, Inc. v. Provident Securities Co., 423 U.S. 232, 243 (1976) (quoting Reliance Elec. Co. v. Emerson Elec. Co., 404 U.S. 418, 422 (1972).
237. *See* Okamoto, *supra* note 3, at 192.

In fact, it may well be that Section 16(b) was never criminalized for the same reason; the drafters never planned to expend considerable resources in prosecuting violators of the law since the expectation was that Section 16(b) would act primarily as an agent of deterrence.[238]

In light of Section 16(b)'s clearly objective criteria, it is understandable why it would seem appropriate to marginalize the introductory purpose clause's role in Section 16(b)'s application. Professor Thel, for one, concluded: "The clause may deserve respect, but when it was inserted, no one suggested that it would control the operative reach of the statute, and by and large it has not."[239] But, while Professor Thel may have been right to observe that the statutory purpose was never meant to control the statutory reach, it is no longer accurate to say that it does not do just that. In fact, Section 16(b)'s introductory purpose clause has assumed a determinative role in the adjudication of Section 16(b) suits that was likely never imagined by its drafters.

This is particularly so in the Second Circuit, which has wholeheartedly embraced the pragmatic approach to Section 16(b) and elevated the purpose clause to the role of arbiter of the orthodoxy and Section 16(b) liability for all transactions undertaken by an insider.[240] To be sure, the statutory purpose is limited by a narrow reading of *Kern County* that confines the unorthodox transaction exception to circumstances in which both *Kern County* factors are present.[241] Yet, as the history of Section 16(b) has shown, the introductory purpose clause has come to overshadow the flat rule and frustrate some of its goals.[242] In fact, most courts have adopted the pragmatic approach, limiting Section 16(b) disgorgement to those instances where the possibility of speculative abuse exists.[243] The SEC has similarly operated under the presumption that the statutory goal is controlling.[244] When the proliferation of derivative securities exposed a gap in the law that insiders could exploit by transacting in derivatives, the SEC exercised its power to protect the goals of Section 16(b) and close the gap.

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238. *See* Jacobs, *supra* note 16, at 348. *But see* Thel, *supra* note 28, at 449–50.

239. Thel, *supra* note 28, at 481. Thel acknowledges that the statutory purpose can play a determinative role in courts' 16(b) adjudication of "unorthodox transactions," but downplays it as "sometimes inform[ing] the construction of the statute." *Id.* at n.334.

240. *See supra* Part II.B.

241. *See supra* Part II.B.

242. *See supra* Part II.

243. *See supra* Part II.A–B.

244. *See supra* Part II.C.

While these adaptations may have been necessary to sustain Section 16(b)'s viability in an age of increasingly complex financial instruments, we should acknowledge at what cost this survival has come. In courts today, Section 16(b) analyses increasingly crop up in the context of unorthodox transactions,[245] a sign that simple administration of the law has become elusive and that the prophylactic quality of Section 16(b) is flailing.[246] The courts' pragmatic approaches require case-specific analyses that belie Section 16(b)'s simple administration. It is that erosion of Section 16(b)'s clear, mechanical operation that has diluted Section 16(b)'s value as a deterrent. Even the purpose clause, which seemingly emerges as the victor, has lost some of its prophylactic luster.

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245. *See* Romeo & Dye, *supra* note 7, at 598.

246. Justice Douglas, in his *Kern County* dissent, argued that the majority's ad hoc unorthodox transaction analysis undermined Section 16(b)'s prophylactic nature. *See* Kern Cnty. Land Co. v. Occidental Petroleum Corp., 411 U.S. 582, 612 (1973) (Douglas, J., dissenting). However, unlike the position advanced in this Note, Justice Douglas limited his criticism to the ad hoc analysis of factual scenarios that clearly met Section 16(b)'s mechanical criteria. *Id.* at 613.