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A Practical Look at Section 16(b) of the Securities Exchange Act

Herbert J. Deitz

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A Practical Look at Section 16(b) of the Securities Exchange Act

Cover Page Footnote

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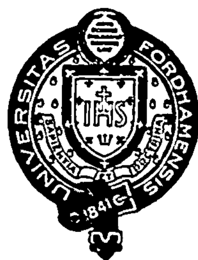

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ADDENDA

Errata

Page 160, note 75. The correct name is Hurley v. Van Lare.
Page 399, note 114. Read as 305 N.Y.S.2d 465.

Subsequent Dispositions of Principal Cases Noted

Page 118, Goldfarb v. Virginia State Bar, 497 F.2d 1 (4th Cir.), *cert. granted,* 95 S. Ct. 223 (1974) (No. 74-70).

Page 128, note 84, United States v. Oregon State Bar was reported at 385 F. Supp. 507.

Page 129, United States v. Alsondo, 486 F.2d 1339 (2d Cir. 1973), *rev'd sub nom.* United States v. Feola, 95 S. Ct. 1255 (1975).

Page 138, SIPC v. Packer, Wilbur & Co. was reported at 498 F.2d 978 (1974).

Page 151, Taylor v. Lavine, 497 F.2d 1208 (2d Cir.), rev'd, 43 U.S.L.W. 4592 (U.S. May 19, 1975).

Page 258, Wilderness Soc'y v. Morton, 495 F.2d 1026 (D.C. Cir. 1974), *rev'd sub nom.* Alyeska Pipeline Serv. Co. v. Wilderness Soc'y, 43 U.S.L.W. 4561 (U.S. May 12, 1975).

Page 288, Jackson v. Statler Foundation, 496 F.2d 623 (2d Cir. 1973), *cert. denied,* 95 S. Ct. 1124 (1975).

Page 329, United States v. Humble Oil & Refining Co., 488 F.2d 953 (5th Cir. 1974), *vacated & remanded,* 43 U.S.L.W. 3583 (U.S. Apr. 28, 1975).

Page 459, Lombard v. Board of Education, 502 F.2d 631 (2d Cir. 1974), *cert. denied,* 43 U.S.L.W. 3500 (U.S. Mar. 17, 1975).

Page 476, Mercado v. Rockefeller, 502 F.2d 666 (2d Cir. 1974), *cert. denied,* 95 S. Ct. 1120 (1975).

Page 820, Chris-Craft Indus., Inc. v. Piper Aircraft Corp., 384 F. Supp. 507 (S.D.N.Y. 1974), *modified,* [Current Binder] CCH Fed. Sec. L. Rep. ¶ 95,058 (2d Cir., Apr. 11, 1975).

Page 1007, note 114 & page 1008, note 117, Smiley v. Smiley was affirmed on May 1, 1975 by the New York Court of Appeals as reported in 173 N.Y.L.J., May 5, 1975, at 1, col. 7.

Page 1037, Gulf Oil Corp. v. Copp Paving Co. is now reported at 419 U.S. 186.

Page 1057, Radcliff v. Anderson was denied certiorari at 43 U.S.L.W. 3572 (U.S. Apr. 21, 1975).

A PRACTICAL LOOK AT SECTION 16(b) OF THE SECURITIES EXCHANGE ACT

*HERBERT J. DEITZ**

I. Introduction

NO fair-minded person will take issue with the dictate of section 16(b) of the Securities Exchange Act.[1] Simply stated, it provides that a director, officer or ten percent beneficial owner who purchases and sells, or sells and purchases, the stock of his corporation (the issuer) within a period of less than six months is accountable to the corporation for the profits he realizes thereby. The expressed intent of the statute is to prevent "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 . . . ."[2]

Despite its clear and equitable mandate, too many apparently well-intentioned corporate executives and beneficial owners, judging by the torrent of litigation since its enactment, failed to recognize the many intricacies and far-reaching tentacles of section 16(b). They did not re-

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1. Section 16(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78p(b) (1970), provides:

"For the purpose of preventing the unfair use of information which may have been obtained by such beneficial owner, director, or officer by reason of his relationship to the issuer, any profit realized by him from any purchase and sale, or any sale and purchase, of any equity security of such issuer (other than an exempted security) within any period of less than six months, unless such security was acquired in good faith in connection with a debt previously contracted, shall inure to and be recoverable by the issuer, irrespective of any intention on the part of such beneficial owner, director, or officer in entering into such transaction of holding the security purchased or of not repurchasing the security sold for a period exceeding six months. Suit to recover such profit may be instituted at law or in equity in any court of competent jurisdiction by the issuer, or by the owner of any security of the issuer in the name and in behalf of the issuer if the issuer shall fail or refuse to bring such suit within sixty days after request or shall fail diligently to prosecute the same thereafter; but no such suit shall be brought more than two years after the date such profit was realized. This subsection shall not be construed to cover any transaction where such beneficial owner was not such both at the time of the purchase and sale, or the sale and purchase, of the security involved, or any transaction or transactions which the Commission by rules and regulations may exempt as not comprehended within the purpose of this subsection." For the legislative history of § 16(b) see H.R. Rep. Nos. 1383, 1838, 73d Cong., 2d Sess. (1934); S. Rep. Nos. 792, 1455, 73d Cong., 2d Sess. (1934).

2. 15 U.S.C. § 78p(b) (1970).

late it, for example, to such common business realities as mergers, stock options, convertible securities, puts, calls and arbitrages, tender offers, gifts of corporate stock, and other transactions seemingly unrelated to the basic hazard of buying and selling, or selling and buying, within a six-month period. They discovered that in some instances liability was imposed although they were not formally elected officers and directors, and in other cases they were not held accountable for their short-swing profits, although they held such positions.

This Article will attempt to point out many of the miscalculations of the past from which may be gleaned some insight into various questions that as yet have not reached the courts. The fortieth anniversary of the enactment of the Securities Exchange Act seems an appropriate occasion to do so.

II. Who May Be Liable

A. *Are You Liable as a Director or Officer?*

1. In General

A director or officer who purchases and sells, or sells and purchases, the stock of his corporation within a period of six months, while maintaining his position in the corporate-issuer, is answerable for his realized profits.[3] Must one be a director or officer at the time of both purchase and sale to be liable? An executive may be held accountable even though he acquired or sold the shares before assuming[4] or after leaving[5] office as long as both transactions occurred within the statutory six-month period and either the purchase or sale occurred while he held office. On the other hand, section 16(b) specifically directs that a ten percent beneficial owner be such at the time of both purchase and sale in order for him to be held accountable.[6] An officer or director will not, however,

3. Id.

4. Adler v. Klawans, 267 F.2d 840, 847 (2d Cir. 1959); Blau v. Allen, 163 F. Supp. 702, 704 (S.D.N.Y. 1958). See Cook & Feldman, Insider Trading Under the Securities Exchange Act, 66 Harv. L. Rev. 612, 632 (1953) [hereinafter cited as Cook & Feldman]; Rubin & Feldman, Statutory Inhibitions Upon Unfair Use of Corporate Information by Insiders, 95 U. Pa. L. Rev. 468, 488 (1947) [hereinafter cited as Rubin & Feldman]. See also 2 L. Loss, Securities Regulation 1060-61 (2d ed. 1961) [hereinafter cited as Loss].

5. See, e.g., Feder v. Martin Marietta Corp., 406 F.2d 260 (2d Cir. 1969), cert. denied, 396 U.S. 1036 (1970).

6. 15 U.S.C. § 78p(b) (1970). Adler v. Klawans, 267 F.2d 840, 845 (2d Cir. 1959). The court pointed out Congress' reason for the distinction: "Generally, although there are important exceptions in certain circumstances, officers and directors have more ready access to the intimate business secrets of corporations and factors which can affect the real and ultimately the market value of stock than does even so large a stockholder as a '10% beneficial owner.'" Id.

incur section 16(b) liability by purchasing and selling stock during a six-month period when both transactions occur after his resignation and retirement.[7]

2. Are You a "Director"?

The Securities Exchange Act defines "director" as "any director of a corporation or *any person* performing similar functions with respect to any organization, whether incorporated or unincorporated."[8] Cause for the uneasiness of corporate executives becomes apparent when one considers that a "person" is defined as "an individual, a corporation, a partnership, an association, a joint-stock company, a business trust, or an unincorporated organization."[9] Construing these definitions together, one realizes, for example, that a director or officer of an issuer, because of his relationship with another "person," might serve the latter in such a manner as to render it also an officer or director of the issuer for the purposes of section 16(b). This concept is referred to as deputization.[10]

In determining whether a deputization has occurred, the courts have examined the particular factual situation presented.[11] Perhaps the most vital factors[12] are whether the director controlled or gave advice relative to the investment policy of the other entity,[13] and whether, in

7. Lewis v. Varnes, 368 F. Supp. 45 (S.D.N.Y. 1974); Levy v. Seaton, 358 F. Supp. 1 (S.D.N.Y. 1973). In such a case, the insider would still have to report it if it occurred "within the calendar month of his resignation (Form 4), but that is not dispositive of a § 16(b) liability." Id. at 5 n.7. However, "[t]he profit anticipated would have to be extraordinary to be the sole cause of resignation from a livelihood." Id.

8. 15 U.S.C. § 78c(7) (1970) (emphasis added).

9. Id. § 78c(9) (1970).

10. Judge Learned Hand originated the theory of deputization in Rattner v. Lehman, 193 F.2d 564, 566 (2d Cir. 1952) (concurring opinion).

11. See, e.g., Blau v. Lehman, 368 U.S. 403, 406-07 (1962); Marquette Cement Mfg. Co. v. Andreas, 239 F. Supp. 962, 967 (S.D.N.Y. 1965). The first case to impose liability based on the deputization theory was Feder v. Martin Marietta Corp., 406 F.2d 260 (2d Cir. 1969), cert. denied, 396 U.S. 1036 (1970).

12. One must beware of generalizations here since the existence of a deputization "is a question of fact to be settled case by case." Marquette Cement Mfg. Co. v. Andreas, 239 F. Supp. 962, 967 (S.D.N.Y. 1965).

13. Feder v. Martin Marietta Corp., 406 F.2d 260, 265 (2d Cir. 1969), cert. denied, 396 U.S. 1036 (1970). There, the president of Feder served as a director of Sperry while Feder bought and sold Sperry stock. The Feder president was "'ultimately responsible for the total operation of the corporation' including personal approval of all the firm's financial investments . . . ." Id. at 264. Thus, his degree of control was crucial since he was in a position where he could acquire inside information and utilize it for his corporation's benefit. It may follow that a director who merely advises his corporation, but who lacks direct controlling influence over its investment policies, would probably be considered a "deputy" since he could utilize this information to direct his firm's investments. Therefore, all minor corporate officers or employees who are directors of an issuing corporation may be con-

serving as a director, he intended to act as a deputy.[14] A formal deputization certainly is not needed to create this relationship.[15] Thus, corporate investment officers and their authorizing superiors may subject their firms to section 16(b) liability as a result of their service as directors and/or officers of other corporations.

Section 16(b) liability may arise in several unsuspecting situations. For example, the trust activities of commercial banks[16] may give rise to liability based on deputization.[17] Also, underwriters and brokerage firms, as well as investment funds, may subject themselves to liability, either as ten percent beneficial owners or pursuant to the deputization theory.[18] Corporations, partnerships, associations, joint stock companies, business trusts and unincorporated organizations can be considered directors or officers for the purpose of section 16(b) and thus may be liable for their short-swing profits.

As a result of the courts' failure to definitively identify the elements of deputization, it is difficult to determine when the theory will be applied. Regardless, one generally can expect the courts to balance all the evidence in order "to determine whether the potential control of the alleged deputy or the independent desirability of his qualifications is more germane to his function on the board of the issuing corporation."[19]

3. Are You an "Officer"?

The definition of an officer for section 16(b) purposes also is far from settled. The SEC defines "officer" as "a president, vice-president, treasurer, secretary comptroller, and any other person who performs for an

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sidered deputies if it can be proved that they are in positions to influence the corporation's investments. This is the point which distinguishes Feder from Blau v. Lehman, 368 U.S. 403 (1962). The partner in Lehman was not in a position to utilize inside information for the benefit of his partnership.

14. 406 F.2d at 265-66. The Feder court also noted, however, that one who is "'ultimately responsible for the total operation of the corporation' . . . " might be considered a deputy even in the absence of corporate intent. Id. at 264-65.

15. The Feder court felt that deputization could be established without any express designation if the facts indicate that the parties had, by their conduct, "intended" to establish a deputy relationship. Id. at 265. See also Colby v. Klune, 178 F.2d 872, 873 (2d Cir. 1949).

16. For an extensive study of the involvement of commercial banks in the control of other corporations through trust department investments, see Subcommittee on Domestic Finance of the House Commission on Banking and Currency, Commercial Banks and Their Trust Activities; Emerging Influence on the American Economy, 90th Cong., 2d Sess., vol. 1 (1968).

17. Where a bank acquires a board position in exchange for the extension of credit, it would seem that the concept of deputization would be applicable.

18. See Wagner, Deputization under Section 16(b): The Implications of Feder v. Martin Marietta Corporation, 78 Yale L.J. 1151, 1170-72 (1969).

19. 38 Geo. Wash. L. Rev. 329, 336 (1969).

issuer, whether incorporated or unincorporated, functions corresponding to those performed by the foregoing officers."[20] The scope and effect of this definition has not been clearly established. In the leading case of *Colby v. Klune*, [21] the court, questioning the validity of this definition of officer for section 16(b) purposes, promulgated a more subjective test:

> [T]here remains much room for inquiring into the facts at a trial. For the functions of a "vice-president" or "comptroller" are not so well settled as to be self-evident, and there is need for evidence concerning those functions. Under that Rule as we interpret it, it does not matter whether or how the by-laws of this particular company define the duties of such officers. The question is what this particular employee was called upon to do in this particular company, i.e., the relation between his authorized activities and those of this corporation.[22]

Thus, the court construed the statute to require a flexible assessment of the particular powers and responsibilities of the alleged "officers," rather than a rigid rule of thumb.[23]

The next problem encountered is the ramifications of the phrase "any other person." The SEC, in its interpretation of the regulation, has expressed the opinion that an assistant treasurer, an assistant secretary and an assistant comptroller are not "officers" unless their chief is inactive to the point of thrusting the burden of the office upon them.[24] The courts first considered whether an assistant treasurer was an "officer" in *Lockheed Aircraft Corp. v. Rathman*.[25] Observing that the functions of the assistant treasurer did not correspond to those performed by the treasurer, who performed all of the executive functions, and that in the treasurer's absence it was the comptroller, and not the assistant treasurer, whose opinion prevailed in executive decisions, the court held the assistant treasurer not to be an "officer."

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20. 17 C.F.R. § 240.3b-2 (1974).
21. 178 F.2d 872 (2d Cir. 1949).
22. Id. at 875.
23. The Colby court observed that officer "includes, inter alia, a corporate employee performing important executive duties of such character that he would be likely, in discharging these duties, to obtain confidential information about the company's affairs that would aid him if he engaged in personal market transactions. It is immaterial how his functions are labelled or how defined in the by-laws, or that he does or does not act under the supervision of some other corporate representative." Id. at 873. The court further suggested the type of evidence which should be elicited by the trial court: "Counsel for the S.E.C., in a memorandum filed with us, says that it is significant that the employee has or has not 'responsibility for the policy of at least a substantial segment of the corporation's affairs' and participates 'in executive councils of the corporation as an officer.' We think the trial court should receive evidence pertinent to that issue but should reserve decision as to its legal significance until after the trial." Id. at 875.
24. See Cole, Insiders' Liabilities Under the Securities Exchange Act of 1934, 12 Sw. L.J. 147, 158 (1958).
25. 106 F. Supp. 810 (S.D. Cal. 1952).

[T]he "other person" provision does not relate to an employee who assists one of the enumerated officers or performs any of the functions of his office during his absence, but relates to an officer, regardless of title, the functions of whose office correspond to those performed by one of the enumerated officers.[26]

The same district court, in *Lockheed Aircraft Corp. v. Campbell*,[27] further elaborated on its rule on somewhat more difficult facts. In *Campbell*, the alleged "officer," who held the titles of assistant treasurer and assistant secretary, was engaged primarily in supervising the mechanical workings of the corporation's finance department, and never performed the functions of his superiors. The court inquired into his actual responsibilities, and finding that "he did not concern himself with financial policy at all,"[28] held him not to be an officer within the meaning of section 16(b). However, the court alerted all officers in corporate enterprises:

[I]t is conceivable that in a corporation like Lockheed, with complex activities, two persons might perform the functions of treasurer, secretary and comptroller, each doing, *within a certain sphere of the corporation's far-flung activities*, exactly the same things.[29]

The modern judicial trend seems to involve an in-depth inquiry into one's actual duties.[30] For example, in the recent case of *Schimmel v. Goldman*,[31] the defendant, in submitting his Form 4,[32] had described himself as vice-president. The district court would have allowed him to show at trial that his position was merely titular, that he had no policy-making functions or access to inside information, and consequently was not an officer for the purposes of section 16(b). In a more recent case,[33]

26. Id. at 813. It is important to note that even if the assistant treasurer were found to be an "officer," nonetheless his transactions might not be susceptible to § 16(b) liability in view of the provision of § 23 of the Act, 15 U.S.C. § 78w(a) (1970), to the effect that no liability will be imposed "to any act done or omitted in good faith in conformity with any rule or regulation of the Commission . . . . " This provision is applicable since in Rathman, the corporation, prior to granting the option to its assistant treasurer to purchase the securities in question, had inquired of the SEC whether or not the assistant treasurer was an "officer," and the SEC had suggested that he was not. It is unclear how the court would have resolved the apparent conflict between § 23 and the rule against estoppel of corporations. See 106 F. Supp. at 814.

27. 110 F. Supp. 282 (S.D. Cal. 1953).

28. Id. at 286 (emphasis omitted).

29. Id. at 284.

30. See Gold v. Sloan, 486 F.2d 340 (4th Cir. 1973), petition for cert. filed, sub nom. Gold v. Scurlock, 42 U.S.L.W. 3623 (U.S. Apr. 30, 1974) (No. 1638).

31. 57 F.R.D. 481 (S.D.N.Y. 1973).

32. Form 4 is the reporting document required by § 16(a). 15 U.S.C. § 78p(a). It is set out in 3 CCH Fed. Sec. L. Rep. ¶ 33,721.

33. Morales v. Holiday Inns, Inc., [1973 Transfer Binder] CCH Fed. Sec. L. Rep.

the same court refused to find the defendant's title (vice-president) merely to be honorary where he had broad access to financial information concerning the issuer. Thus, one's title may be deemed merely titular so that he is not an officer for section 16(b) purposes, but in order to ensure such a determination, there should be neither access to inside information nor influence in policy decisions.

Another problem in determining who is an "officer" involves the interpretation of the term "issuer." The Act defines issuer as "any person who issues or proposes to issue any security . . . . "[34] The courts have been reluctant to broaden the express language of the statute, restricting themselves to constructions in accordance with congressional objectives.[35] Thus, it has been held that an officer of a subsidiary of an issuer is not an officer of the issuer, unless it is proved that he actually performs the functions of an officer for the parent corporation.[36]

B. *Are You a "Beneficial Owner"?*

The third and final group subject to liability are "beneficial owners" —those who own ten percent of a class[37] of equity stock (preferred or common) or own convertible debentures which, if converted, would constitute ten percent of a class of equity stock of a corporation.[38] The SEC has expanded this category by opining that, absent special circumstances,[39] a person is generally regarded as the beneficial owner of se-

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¶ 94,219 (S.D.N.Y. 1973). See also Selas Corp. v. Voogd, 365 F. Supp. 1268 (E.D. Pa. 1973), wherein a motion for summary judgment was granted upon a finding that Voogd was an "officer," although Voogd contended that he was merely a figurehead. The court deemed it controlling that Voogd had been an active member of the firm's executive committee, was chief operating officer of the main division of the firm, had intimate knowledge of the operations of the firm, and had a substantial voice in policy decisions.

34. 15 U.S.C. § 78c(a)(8) (1970).

35. See Gold v. Sloan, 486 F.2d 340, 358 (4th Cir. 1973) petition for cert. filed, sub nom. Gold v. Scurlock, 42 U.S.L.W. 3623 (U.S. Apr. 30, 1974) (No. 1638) (dissenting opinion); Feder v. Martin Marietta Corp., 406 F.2d 260, 262-63 (2d Cir. 1969), cert. denied, 396 U.S. 1036 (1970); Lee Nat'l Corp. v. Segur, 281 F. Supp. 851 (E.D. Pa 1968); Blau v. Oppenheim, 250 F. Supp. 881 (S.D.N.Y. 1966).

36. Lee Nat'l Corp. v. Segur, 281 F. Supp. 851 (E.D. Pa. 1968).

37. In Ellerin v. Massachusetts Mut. Life Ins. Co., 270 F.2d 259 (2d Cir. 1959), a corporation issued two series of preferred stock, differing as to annual dividend rates, redemption prices, sinking fund accumulation rates, dates of issuance, registration, listing and commencement of dividend payments, and voting rights. The court held that the owner of 13% of the issued stock of one "series" was not a beneficial owner of more than 10% of any "class" of equity security. Thus, "a 'class' is not a 'series' within the meaning of Section 16." Id. at 263.

38. Chemical Fund, Inc. v. Xerox Corp., 377 F.2d 107, 110-11 (2d Cir. 1967) (since defendants, upon conversion of convertible debentures, would have held less than ten percent of a class of equity securities, they were not held liable).

39. In Blau v. Potter, [1973 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 94,115 (S.D.N.Y.

curities held in the name of his or her spouse and their minor children.[40] The expansive scope of section 16(b) is comparatively restrained with respect to "beneficial owners," since the section is inapplicable "where such beneficial owner was not such both at the time of the purchase and sale, or the sale and purchase, of the security involved . . . ."[41] The importance of this language is discussed elsewhere in this Article.[42]

III. What Transactions May Give Rise To Liability

A. *You May Be Liable For Your Gifts*

The Act does not specifically include gifts within its definition of "sales." Under the Act, "sale" refers only to "any contract to sell or or otherwise dispose of" securities.[43] Although it could be argued that to "otherwise dispose of" necessarily includes the making of a gift,[44] the courts have determined that gifts usually are not "sales," on the basis that "there is no profit possible in such transactions, and hence no danger of short-term speculation."[45]

The leading case for the proposition that charitable gifts are not "sales" is *Truncale v. Blumberg*.[46] There, a stockholder sought to recover on behalf of the corporation alleged profits obtained by a corporate officer when the latter made gifts of warrants to bona fide charitable organizations within six months of his acquisition of the warrants. Although the court noted that the term "sale" should be given a broad interpretation in order to eliminate all incentive to profit from confiden-

1973), the court held that no benefit inured to the officer from the securities purchased by his wife. The court relied on several "special circumstances:" the wife maintained her own brokerage account with her own funds and conducted trading activities without his advice; none of her funds contributed to the maintenance of their household nor were they mingled with his funds in any way; the officer never discussed the company's affairs with his wife and specifically refrained from revealing the company's prospects. Id. at 94,477-78.

40. SEC Securities Exchange Act Release No. 7793 (Jan. 19, 1966). "A person also may be regarded as the beneficial owner of securities held in the name of another person if . . . he obtains therefrom benefits substantially equivalent to those of ownership . . . [or] if he can vest or revest title in himself at once, or at some future time." Id.

41. 15 U.S.C. § 78p(b) (1970).

42. See text accompanying notes 4-7 supra.

43. 15 U.S.C. § 78c(14) (1970).

44. Compare the views of Judge Clark, dissenting in Shaw v. Dreyfus, 172 F.2d 140, 143 (2d Cir.), cert. denied, 337 U.S. 907 (1949) with Truncale v. Blumberg, 80 F. Supp. 387 (S.D.N.Y. 1948). Judge Clark concluded that "[t]he statutory language is . . . inclusive enough to reach these transactions." 172 F.2d at 143.

45. Comment, The Scope of "Purchase and Sale" Under Section 16(b) of the Exchange Act, 59 Yale L.J. 510, 527 (1950).

46. 80 F. Supp. 387 (S.D.N.Y. 1948).

tial information,[47] it foresaw no possibility of profiting[48] by means of bona fide[49] gifts, even though the officer, by deducting them on his tax returns as charitable contributions, gained some economic benefit.[50] In *Shaw v. Dreyfus*,[51] a bona fide gift was found not to constitute a sale within the meaning of section 16(b) even where the gift was for a non-charitable purpose.

However, in both *Truncale* and *Shaw* there was no subsequent sale by the donee within the six-month period after the donor's initial acquisition. Where such a sale does occur, the SEC has suggested two alternative approaches: first, the SEC would view the donor-donee transfer as a gift, with the effect of placing the donee in the shoes of the donor.[52] Thus, the SEC would require the donor to account for the profit resulting from the donee's subsequent sale. One obvious problem with this recommendation is the difficulty in ascertaining the fact of the donee's sale. Also, the SEC disregards the fact that there is no economic benefit accruing to the donor,[53] whether or not the donee resells. The second proposed theory is to treat *every* non-charitable gift as a sale, even where the donee retains the securities, thereby holding the donor accountable for "the amount of any market increment at the time of the gift."[54]

Both theories were rejected by the *Truncale* court. Under its view, a gift is not a "sale" unless the circumstances surrounding the donee's sale, made within six months of the donor's purchase, disclose that the donee "was in effect an *alter ego* of the officer or director or beneficial

47. "In this particular context it seems clear that these terms must be given the broadest possible connotation, consistent with the fundamental meaning of the words 'sale' and 'purchase,' which will best effectuate the express purpose of the statute to remove all incentive to insiders to profit on short-swing transactions from confidential information available only to them because of their position of trust." Id. at 390-91. See Rubin & Feldman 485.

48. "By no stretch of the imagination . . . can a gift to charity or indeed to anyone else when made in good faith and without pretense or subterfuge, be considered a sale or anything in the nature of a sale. It is the very antithesis of a sale . . . ." 80 F. Supp. at 391.

49. While a charitable gift may not be a "sale" within the purview of § 16(b), it is not exempt from the effect of that section unless the gifts are bona fide. Blau v. Albert, 157 F. Supp. 816, 820 (S.D.N.Y. 1957).

50. "In any event, the statute in question was designed to prevent short-swing speculation by corporate executives and insiders and no amount of tax dodging, even if it were present, could possibly be detrimental to the rights of the other security holders or to the corporation, so far as appears in this record." 80 F. Supp. at 391.

51. 172 F.2d 140 (2d Cir.), cert. denied, 337 U.S. 907 (1949).

52. Truncale v. Blumberg, 80 F. Supp. 387, 392 (S.D.N.Y. 1948).

53. See Comment, supra note 45, at 528-31.

54. 80 F. Supp. at 392.

owner and that the sale was really made by him."[55] The court in *Shaw*, however, left open the question of whether recovery could be had if the stock had been sold within six months.[56] Thus, the Second Circuit has not committed itself to the alter ego rule or the SEC's theory of placing the donee in the donor's shoes. Regardless, one is always susceptible to a challenge of the bona fide nature of the gift.[57]

An SEC regulation excludes from section 16(b) liability any gifts which do not exceed $3,000 in market value[58] where the gift transaction "is otherwise subject to the provisions of section 16(b)."[59] However, since *Truncale* and *Shaw* have determined that a bona fide gift will not give rise to liability, the regulation is academic in such cases.[60]

In summary, it appears that the bona fide nature of the gift is of critical importance. Although the view that a bona fide gift is not a "sale" permits avoidance of statutory liability, one must beware of violating the section's purpose.[61] Judge Clark, in his dissent in *Shaw*, stressed that gifts do result in economic benefits, if not profits, for the donor.[62] Therefore, despite the minimization of the tax-avoidance motive in *Truncale*,[63] a court might impose section 16(b) liability where a contribution results in a substantial tax deduction, and the entire transaction is "susceptible to defeating the purpose of the statute."[64]

B. *Debt Transactions*

In addition to the specific exemptions created by the SEC, section 16(b) provides a general exemption permitting the sale, at any time, by

55. Id. at 391 (emphasis added).

56. 172 F.2d at 143.

57. See Blau v. Albert, 157 F. Supp. 816, 820 (S.D.N.Y. 1957), where the court, because of this possibility, denied the defendant's motion for summary judgment.

58. 17 C.F.R. § 240.16a-9(b) (1974) provides: "Any acquisition or disposition of securities by way of gift, where the total amount of such gifts does not exceed $3,000 in market value for any six months period, shall be exempt from section 16(a) and may be excluded from the computations prescribed in paragraph (a)(2) of this section."

59. Id. § 240.16a-10 (1974) provides: "Any transaction which has been or shall be exempted by the Commission from the requirements of section 16(a) shall, insofar as it is otherwise subject to the provisions of section 16(b), be likewise exempted from section 16(b)."

60. Lewis v. Adler, 331 F. Supp. 1258, 1267-68 (S.D.N.Y. 1971).

61. "[T]he courts will resolve the question in the way which will best effectuate the express purpose of the statute to remove all incentive to insiders to profit from confidential information available only to them because of their position of trust." Rubin & Feldman 485.

62. 172 F.2d at 143. For various ways in which gifts may constitute a substantial economic benefit, see Comment, The Scope of "Purchase and Sale" Under Section 16(b) of the Exchange Act, 59 Yale L.J. 510, 528-31 (1950).

63. 80 F. Supp. at 391.

64. Rubin & Feldman 485.

insiders where the security "was acquired in good faith in connection with a debt previously contracted."[65] By its very terms, the exemption's operation depends upon the existence of three elements: "a previously contracted debt,"[66] an acquisition of stock "in connection with" the debt, and an acquisition in "good faith." Thus, the exemption was unavailable where a corporate director or officer acquired stock and disposed of it in *payment* of a debt.[67] Although "acquired . . . in connection with" seems broad enough to encompass any debt payment effected through the transfer of stock, such an interpretation would emasculate the purpose of section 16(b) since profits otherwise recoverable "could be washed out by the simple expedient of borrowing money to be repaid in stock."[68]

The exemption was allowed in the leading case of *Rheem Manufacturing Co. v. Rheem*,[69] where the defendant-officer received corporate securities in satisfaction of his interest in the corporation's retirement plan. As a convenience to the corporation's accounting department, the defendant was given a check for the amount of his vested interest, and the corporation simultaneously accepted his personal check for corporate stock in that amount. The defendant thereupon pledged this stock as security for a pre-existing obligation, and there was a forced liquidation of the stock by his creditor within six months. The court decided that Rheem's employer had "an obligation to pay a fixed sum certainly and at all events, existing prior to and apart from the settlement of the obligation by the transfer of stock . . . ."[70] The court also viewed the two-check settlement as one transaction and thus in compliance with the requirement of an acquisition "in connection with" a prior debt.[71]

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65. 15 U.S.C. § 78p(b) (1970).

66. It has been held that no "debt previously contracted" exists where a shareholder receives common stock upon the redemption of his preferred stock. Park & Tilford, Inc. v. Schulte, 160 F.2d 984, 987 (2d Cir.), cert. denied, 332 U.S. 761 (1947); Kogan v. Schulte, 61 F. Supp. 604, 607-08 (S.D.N.Y. 1945). The courts have relied on the fact that the preferred stock merely represented an interest in equity, and not an actual debt. See 160 F.2d at 987. Similarly, acquisitions of stock through the exercise of a non-assignable option to buy have been held not covered by the exemption. Blau v. Ogsbury, [1952-1956 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 90,635, at 91,929 (S.D.N.Y. 1953), aff'd, 210 F.2d 426 (2d Cir. 1954) (no consideration of the exemption on appeal). Even where stock was acquired through warrants issued as part of the consideration for the insider's services to the corporation, the employment contract pursuant to which the warrants were issued was held not to be a "debt" for the purposes of the exemption. Truncale v. Blumberg, 80 F. Supp. 387 (S.D.N.Y. 1948).

67. Smolowe v. Delendo Corp., 136 F.2d 231, 239 (2d Cir.), cert. denied, 320 U.S. 751 (1943).

68. Id. See also Lewis v. Adler, 331 F. Supp. 1258, 1267 (S.D.N.Y. 1971).

69. 295 F.2d 473 (9th Cir. 1961).

70. Id. at 476.

71. "The exchange of checks and the delivery of stock was in fact all one transaction.

The outcome of the case depended upon the existence of good faith. The plaintiff contended that, in order to establish his good faith, the defendant must prove that he acquired the stock in a wholly involuntary manner. Although the court noted that this was, at one time, the test of good faith,[72] it pointed out that the strict objective standard has been abandoned in favor of a subjective intent theory of good faith.[73] Thus, the element of choice in the acquisition is merely one factor to be considered in determining good faith. Several other factors may arouse a court's interest as to one's good faith: the purpose for which the securities were acquired,[74] whether the purchaser intended to sell within six months, and the nature of the subsequent sale.[75] In short, the courts will evaluate closely the possibility that the transactions might derive from unfair use of inside information.[76]

C. *Employment Compensation and Its Relationship to Section 16(b)*

Rule 16b-3, in its present form,[77] exempts from section 16 a director's or officer's acquisition of "non-option stock pursuant to a bonus, profit-

'In connection with' is broader than 'in direct discharge of,' and contemplates the kind of integrated settlement which took place." Id.

72. See Perlman v. Timberlake, 172 F. Supp. 246, 255 (S.D.N.Y. 1959). One law review article stated that "[s]o long as the requirement of 'good faith' is satisfied—presumably it would not be where the substitution of securities in satisfaction of the claim was at the choice of the creditor—the opportunities for abuse of inside information would not be present." Cook & Feldman 633. Another article noted: "If it was not clearly necessary to take stock in payment, then we believe the courts will hold it not within the exception contained in Section 16(b)." Rubin & Feldman 487.

73. 295 F.2d at 477.

74. In Rheem, since the defendant had originally intended to use the securities to build his estate over a long period, and since the securities had been sold in a forced liquidation, the court determined that the defendant was subjectively in good faith. Id.

75. Id.

76. The Rheem court suggested "that there may . . . be cases so shot through with the possibilities of unfair speculation that a party cannot overcome the strong inference of bad faith." Id.

The standards established by Rheem still exist today. For example, in Varian Assoc. v. Booth, 224 F. Supp. 225 (D. Mass. 1963), aff'd, 334 F.2d 1 (1st Cir. 1964), cert. denied, 379 U.S. 961 (1965), the court refused to apply the exemption to a mere contract to purchase stock, not only because a contrary ruling would permit evasion of the statute, 224 F. Supp. at 227, but also because the delivered stock was not independent of the obligation. In fact, the First Circuit distinguished Smolowe and Rheem from Booth expressly on this issue of independence. 334 F.2d at 5-6. Similarly, in Heli-Coil Corp. v. Webster, 352 F.2d 156, 168 (3d Cir. 1965), aff'g 222 F. Supp. 831, 835 (D.N.J. 1963), defendants contended that the acquisition of common stock through the conversion of debentures was "in connection with a debt previously contracted." The Court of Appeals for the Third Circuit disagreed because the debt obligation did not exist prior to and apart from the settlement that occurred when the stock was transferred. Id. at 168-69.

77. 17 C.F.R. § 240.16b-3 (1974). Initially, the rule did not exempt the qualified stock

sharing, retirement or similar plan, and . . . qualified or restricted stock *options* or stock *options* pursuant to employee stock purchase plans (but not the optioned *shares*) within the meaning of §§422-24 of the Internal Revenue Code as amended in 1964."[78] The rule has become a trap for many a corporate investor who through lack of knowledge or simple carelessness failed to act within its guidelines. The stated criteria—majority shareholder approval of exempted plans,[79] limitations on the class of individuals administering these plans,[80] and restrictions on the number of shares each participant may receive[81]—are such that compliance

option plan at all, but was amended in order to mirror congressional approval of such plans. See Note, Corporate Insiders, Stock Options and Rule X-16b-3 of the Securities Exchange Commission, 54 Nw. U.L. Rev. 638, 640-41 (1959). Due to judicial determination that the exercise of such options should not be included in the exemption, see Greene v. Deitz, 247 F.2d 689 (2d Cir. 1957), the present rule exempts only the acquisition of the option.

78. 2 Loss 1114; 5 Loss 3080 (Supp. 1969).

79. SEC Securities Exchange Act Release No. 8592 (May 1, 1949). The applicable law of the jurisdiction may be complied with in the meeting originally giving majority approval to the plan. However, if approval is not solicited in substantial compliance with the federal proxy regulations, the same information required by such regulations must be forwarded to the shareholders.

80. Rule 16b-3(b) provides in part:

"If the selection of any director or officer of the issuer to whom stock may be allocated or to whom qualified, restricted or employee stock purchase plan stock options may be granted pursuant to the plan, or the determination of the number or maximum number of shares of stock which may be allocated to any such director or officer or which may be covered by qualified, restricted or employee stock purchase plan stock options granted to any such director or officer, is subject to the discretion of any person, then such discretion shall be exercised only as follows:

(1) With respect to the participation of directors;

(i) By the board of directors of the issuer, a majority of which board and a majority of the directors acting in the matter are disinterested persons;

(ii) By, or only in accordance with the recommendation of, a committee of three or more persons having full authority to act in the matter, all of the members of which committee are disinterested persons; or

(iii) Otherwise in accordance with the plan, if the plan (a) specifies the number or maximum number of shares of stock which directors may acquire or which may be subject to qualified, restricted or employee stock purchase plan stock options granted to directors and the terms upon which, and the times at which or the periods within which, such stock may be acquired or such options may be acquired and exercised; or (b) sets forth, by formula or otherwise, effective and determinable limitations with respect to the foregoing based upon earnings of the issuer, dividends paid, compensation received by participants, option prices, market value of shares, outstanding shares or percentages thereof outstanding from time to time, or similar factors.

(2) With respect to the participation of officers who are not directors:

(i) By the board of directors of the issuer or a committee of three or more directors; or

(ii) By, or only in accordance with the recommendations of, a committee of three or more persons having full authority to act in the matter, all of the members of which committee are disinterested persons." 17 C.F.R. § 240.16b-3(b) (1974).

81. Rule 16b-3(c) provides:

is easy enough so as to make noncompliance foolhardy. The rule also incorporates the Internal Revenue Code's definitions of qualified stock options,[82] employee stock purchase plans,[83] and restricted stock options.[84]

"As to each participant or as to all participants the plan effectively limits the aggregate dollar amount or the aggregate number of shares of stock which may be allocated, or which may be subject to qualified, restricted, or employee stock purchase plan stock options granted, pursuant to the plan. The limitations may be established on an annual basis, or for the duration of the plan, whether or not the plan has a fixed termination date; and may be determined either by fixed or maximum dollar amounts or fixed or maximum number of shares or by formulas based upon earnings of the issuer, dividends paid, compensation received by participants, option prices, market value of shares, outstanding shares or percentages thereof outstanding from time to time, or similar factors which will result in an effective and determinable limitation. Such limitation may be subject to any provisions for adjustment of the plan or of stock allocable or options outstanding thereunder to prevent dilution or enlargement of rights." 17 C.F.R. § 240.16b-3(c) (1974).

82. A Qualified Stock Option is an option granted to an insider after December 31, 1963 for any reason connected with his employment by the corporation. It must be granted by the employer corporation or its parent or subsidiary corporation, to purchase its stock. The Internal Revenue Code requires that a qualified stock option plan meet the following criteria: it must specify the aggregate amount of issuable shares and the employees or class of employees eligible to participate; it must have shareholder approval within 12 months before or after adoption; it must be granted within ten years of the date of the plan's adoption; the optionee cannot be allowed more than five years to exercise the option; such option should normally be exercisable at the fair market value price of the stock when granted; the optionee cannot exercise a subsequently granted option until all prior options have been exercised; the option is not transferable except by descent; and the plan must exclude those individuals who own more than five percent of either the total combined voting power or the value of all classes of stock in the corporation. Int. Rev. Code of 1954, § 422(b).

83. Employee Stock Purchase Plans are subject to the following definitional limitations in order to meet the requirements of the Code: options issued under the plan may be granted only to employees of the corporation or of a parent or subsidiary; the plan must be approved by a majority of the shareholders within twelve months before or after the commencement of the plan; the plan may not include individuals owning five percent or more of the stock of the corporation; the plan may not exclude employees of the corporation from participation unless the employee has been employed less than two years, or works less than twenty hours a week, or where customary employment is for not more than five months (however, highly paid officers may be excluded from the plan); and employees participating in the plan must have the same rights and privileges under it. The major exception to this qualification allows the amount of options obtainable by an employee to be determined by the amount of compensation he receives. Of course, the plan may also put a ceiling on the amount of stock each employee may acquire through the plan. Furthermore, the option price of the underlying security must be at least 85% of the fair market price of the stock when granted, or when exercised; if the price of the stock is tied to its fair market value when exercised, the grantee may exercise the option within five years of receiving it (however, if the market price is related to the fair market value of the underlying security when the option was granted, the grantee must exercise the option within twenty-seven months); and no employee may, through the plan, accrue rights permitting him to obtain more than $25,000 of the fair market value of the stock for each calendar year in which such option is outstanding. Id. § 423(b).

84. A Restricted Stock Option is limited by the following three requirements: the option

In so doing, the SEC requires that stock option plans conform, not only to the SEC requirements, but also to those set out in the Internal Revenue Code definitions.

That all these qualifications must be complied with literally if the owner of a stock option wishes to avail himself of the rule's exemptive effects is demonstrated plainly in the case of *Volk v. Zlotoff.*[85] The defendant, an officer of the Yoo-hoo Corporation, sold stock in the corporation in order to raise money so that he could exercise a previously granted option. This action was taken at the behest of Yoo-hoo Corporation in order to provide it with needed working capital. Yoo-hoo's counsel had incorrectly advised the defendant that this action would not result in section 16(b) liability. The corporation, upon discovery that this was untrue, allowed the defendant to rescind the exercise of his option. In spite of these countervailing considerations, the court refused to give rule 16b-3 a liberal reading, and forced the defendant to surrender his profits.[86] The only consolation for the defendant was a second exemption, rule 16b-6, which limited his liability.[87]

price must be at least 85% of the fair market value of the underlying security when the option was granted; the option may not be transferred while the grantee is alive; and the grantee of such an option must not own more than ten percent of the stock in the corporation or one of its parents or subsidiaries. There is a limited exception to this third qualification—the owner of more than ten percent may receive an option which prices the underlying security at 110% of its current fair market value, if the option may not be exercised for five years. Id. § 424(b).

It should be recognized that although restricted stock options are no longer treated favorably by the Internal Revenue Code if they were granted after January 1, 1964, the SEC still includes them within the purview of the exemption. 5 Loss 3080 (Supp. 1969).

85. 285 F. Supp. 650 (S.D.N.Y. 1968).

86. The court stated in support of its decision, that, "[t]his rescission was not in the least detrimental to defendants: they were reinvested by the rescission with the very same stock options, which they could exercise in the future, and they retained the profits from the sales. If anything, the practical outcome of the rescission was to benefit the insiders . . . ." Id. at 657.

87. This was decided in a connected case, Volk v. Zlotoff, 318 F. Supp. 864 (S.D.N.Y. 1970). Rule 16b-6 provides:

"(a) To the extent specified in paragraph (b) of this section the Commission hereby exempts as not comprehended within the purposes of section 16(b) of the act any transaction or transactions involving the purchase and sale or sale and purchase of any equity security where such purchase is pursuant to the exercise of an option or similar right either (1) acquired more than six months before its exercise, or (2) acquired pursuant to the terms of an employment contract entered into more than six months before its exercise.

(b) In respect of transactions specified in paragraph (a) of this section the profits inuring to the issuer shall not exceed the difference between the proceeds of sale and the lowest market price of any security of the same class within six months before or after the date of sale. Nothing in this section shall be deemed to enlarge the amount of profit which would inure to the issuer in the absence of this section." 17 C.F.R. § 240.16b-6 (1974). For cases interpreting the effects of this rule, see Kornfeld v. Eaton, 327 F.2d 263 (2d Cir. 1964); cf. B.T. Babbitt, Inc. v. Lachner, 332 F.2d 255 (2d Cir. 1964); Steinberg v. Sharpe, 95 F. Supp.

An obvious lesson to be learned from *Volk* and from other opinions[88] and SEC no-action letters[89] is that strict adherence to the letter of rule 16b-3 is far less burdensome than its alternatives—expensive litigation and the likelihood that courts, in the face of all the equities, will force such unwary investors to disgorge their profits.

D. *Puts, Calls and Straddles—Options Granted by Parties Other Than the Issuer*

The legislative history of section 16(b) indicates not only that Congress recognized options to be susceptible to abuse by insiders, but also that Congress regarded them to be at the root of the evils of insider short-swing activity.[90]

> [T]he granting of options to pools and syndicates has been found to be at the bottom of most manipulative operations, because the granting of these options permits large-scale manipulations to be conducted with a minimum of financial risk to the manipulators.[91]

In determining the applicability of section 16(b) in this area, the courts have considered whether options granted by persons other than the issuer constitute "purchases" and "sales" of the underlying equity security, and in some cases have decided that they do.[92] It also has been

32 (S.D.N.Y. 1950), aff'd, 190 F.2d 82 (2d Cir. 1951) (per curiam). See generally, Palmer, Computing Section 16(b) Profits on Stock Bought Under Option: Applying Rule 16b-6, 25 Bus. Law. 1269 (1970).

88. Brenner v. Career Academy, Inc., 467 F.2d 1080 (7th Cir. 1972); Keller Indus., Inc. v. Walden, 462 F.2d 388 (5th Cir. 1972).

89. Faberge, Inc., [1972-1973 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 79,114 (1972); Amerada Hess Corp., [1971-1972 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 78,780 (1972); First Wis. Bankshares Corp., [1970-1971 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 77,997 (1970).

90. See Michaely & Lee, Put and Call Options: Criteria for Applicability of Section 16(b) of the Securities Exchange Act of 1934, 40 Notre Dame Law. 239 (1965).

91. Id. at 249, quoting H.R. Rep. No. 1383, 74th Cong., 2d Sess. 10-11 (1934).

92. In Bershad v. McDonough, 428 F.2d 693 (7th Cir. 1970), cert. denied, 400 U.S. 992 (1971), the court found a "call" option to be a sale of the underlying security. In so finding, it noted that:

"The commercial substance of the transaction rather than its form must be considered, and courts should guard against sham transactions by which an insider disguises the effective transfer of stock." Id. at 697.

The Bershad court found these factors to be determinative: first, that the purchase price of the call equaled more than fourteen percent of the value of the underlying stock; second, that the stocks were placed in escrow with their transfer; and finally, that the defendant resigned from the corporation's board of directors pursuant to the option agreement. Id. at 698. But see Kern County Land Co. v. Occidental Petroleum Corp., 411 U.S. 582, 601-04 (1973), where a similar call option was ruled not to be a § 16(b) sale. The Supreme Court found that the option in Kern did not provide the defendant with the access to inside information and opportunity for its abuse necessary in order to ground liability.

recognized that puts and calls can be vehicles of insider speculation and resulting profits.[93] Here again, the facts in each case will be controlling.[94] For the purposes of this Article, suffice it to say that speculative activity in the area of puts and calls can very well result in the surrendering of profits pursuant to section 16(b).

E. *Arbitrage Transactions*

"Arbitrage" usually refers to the sale and purchase of the same or similar securities in order to exploit the price differences existing between two different markets at approximately the same time.[95] Thus, for example, preferred stock which is convertible into common may be purchased to cover a short sale of the latter.[96]

Section 16(e) of the Act specifically exempts arbitrage transactions

93. Miller v. General Outdoor Advtg. Co., 337 F.2d 944 (2d Cir. 1964). For an in-depth study of the Miller decision, see Michaely & Lee, Put and Call Options: Criteria For Applicability of Section 16(b) of the Securities Exchange Act of 1934, 40 Notre Dame Law. 239 (1965). See also Comment, Put and Call Options Under Section 16 of the Securities Exchange Act, 69 Yale L.J. 868 (1960).

94. For an excellent discussion of the policy considerations relied upon by courts making such determinations, see Laufer, Effect of Section 16(b) of the Securities Exchange Act on Use of Options by Insiders, 8 N.Y.L.F. 233 (1962).

95. 2 Loss 1108 n.276; 54 Colum. L. Rev. 425, 427 (1954). The Second Circuit, in Falco v. Donner Foundation, Inc., 208 F.2d 600, 603 (2d Cir. 1953) (citations omitted), noted the various aspects of arbitrage: "Arbitrage is nowhere defined in the statute. In ordinary usage it refers to a specialized form of trading which is said to be based upon disparity in quoted prices of the same or equivalent commodities, securities, or bills of exchange. In its most common form it involves purchase of a commodity against a present sale of the identical commodity for future delivery—time arbitrage; or a purchase in one market . . . against a sale in another . . .—space arbitrage. There is also a third, somewhat less common, form—kind arbitrage. This consists of a purchase of a security which is, without restriction other than the payment of money, exchangeable or convertible within a reasonable time into a second security, together with a simultaneous offsetting sale of the second security. . . . Thus an arbitrager may buy warrants or rights to buy stock, simultaneously selling short the stock itself, and subsequently covering the short sale by exercising his right or warrant. It will readily be seen that for all practical purposes a convertible bond is equivalent to the number of shares of stock into which it is convertible. A right or warrant plus the subscription price is theoretically equivalent to the stock on which the right or warrant has a call."

96. Falco v. Donner Foundation, Inc., 208 F.2d 600, 603-04 (2d Cir. 1953). Since a "straddle" is not a purchase and sale within the purview of § 16(b), it is obviously not an arbitrage transaction within § 16(e). Silverman v. Landa, 306 F.2d 422, 425 (2d Cir. 1962). In Chemical Fund, Inc. v. Xerox Corp., [1964-1966 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 91,653 at 95,418 (W.D.N.Y. 1966), rev'd on other grounds, 377 F.2d 107 (2d Cir. 1967), the court held that an investment company's open-end purchases of convertible debentures and sales of common stock, which were claimed to be offset transactions, were not arbitrage transactions. The court noted that the fact that the defendant did not refer to or characterize them as arbitrage transactions was relevant but not conclusive.

from the scope of section 16(b) if not made in contravention of SEC regulations.[97] The SEC has withdrawn this exemption with respect to officers or directors, but ten percent stockholders may engage in arbitrage without incurring liability.[98]

The rationale of the exemption is that the nature of the transaction is such as to insulate it from any wrongful use of inside information. The insider normally is on the same footing with other traders[99] and his profit potential does not depend on the financial status of the issuer, but rather on the coincident state of the markets.[100]

While absolutely simultaneous purchases and sales are not required,[101] a "substantial" interval and market movement separating the acquisition and disposal may operate to create liability.[102] "Substantial" has not been, and probably cannot be, defined in this context—a four month delay has been held to be "substantial,"[103] and it has been suggested that even two hours may be sufficient to trigger section 16(b) liability.[104]

IV. The Unorthodox Transaction

The "unorthodox transaction" is a term of art most often used by courts as a descriptive term for mergers and stock reclassifications. Because of the peculiar nature of such transactions with respect to section 16(b), a discussion of the statute's application to each is in order.

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97. Section 16(e) provides:

"The provisions of this section [§ 16] shall not apply to foreign or domestic arbitrage transactions unless made in contravention of such rules and regulations as the Commission may adopt in order to carry out the purposes of this section." 15 U.S.C. § 78p(e) (1970).

98. 17 C.F.R. § 240.16e-1 (1973). However, the rule grants a complete exemption from § 16(c). See generally Lewis v. The Dekcraft Corp., [1973-1974 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 94,620 (S.D.N.Y. June 27, 1974).

99. In Falco v. Donner Foundation, Inc., 208 F.2d 600 (2d Cir. 1953), a ten percent stockholder sold the issuer's securities cum dividend on the day of record (before receiving an anticipated dividend) and simultaneously purchased an equal number of its securities ex dividend. The court exempted the transactions because the elements of arbitrage existed: the defendant knew and relied upon the existing price differentials and their relationships, the defendant's position in the issuer's securities remained unaffected throughout the transactions, and there was a simultaneous sale and purchase. Id. at 603-04.

100. Id. at 604.

101. Id. at 603 n.3.

102. Id. at 604 n.4.

103. Heli-Coil Corp. v. Webster, 222 F. Supp. 831, 837 (D.N.J. 1963), modified on other grounds, 352 F.2d 156, 159 (3d Cir. 1965).

104. Cook & Feldman 391. "The arbitrage must, of course, be a bona fide arbitrage. A purchase at the close of the New York market and a sale two hours later in San Francisco would not meet the requirement of bona fides." Id.

A. *Stock Reclassification*

An insider's receipt of stock pursuant to a corporate stock reclassification has been held not to constitute a purchase of stock within the meaning of section 16(b) where the reclassification could not possibly lead to the type of speculation which the statute is intended to prevent. This statement is a simplification of the holding of *Roberts v. Eaton*,[105] which involved a typical reclassification situation. Defendant, a director and owner of 45 percent of the outstanding shares of the public corporation which had only common stock authorized, sought a reclassification into preferred and common stock. He obtained the approval of 78 percent of the stockholders through a proxy solicitation which disclosed that his purpose was to increase the market value of his holdings so as to facilitate their sale. Less than a month after the reclassification, the defendant sold all his holdings.

Although the Court of Appeals for the Second Circuit decided that the receipt of the reclassified stock was not a purchase for the purposes of section 16(b), it declined to enunciate a "black-letter rubric."[106] In holding the reclassification not to have been a purchase, the court relied predominantly on three factors. First, the court noted that the necessarily equal treatment of all stockholders was at least a partial safeguard against unfair transactions.[107] Secondly, the reclassified stock received was a new issue which had no pre-existing market value.[108] Thirdly, the defendant's proportionate interest in the issuing corporation remained the same after the reclassification, a factor suggesting that the change in holdings was more one of form than of substance.[109] The court, although describing this factor as "essential," relied on the cumulative effect of all three factors "to immunize the transaction from application of the statute."[110]

105. 212 F.2d 82 (2d Cir.), cert. denied, 348 U.S. 827 (1954).

106. Id. at 85.

107. Id.

108. The court reasoned that since the value of a new stock issue is related directly to the underlying business assets, any difference in market price between the old and new issue is due to the public's preference for a particular type of stock rather than to matters of which an insider might have special, advantageous knowledge. Id.

109. Id. at 86. However, Blau v. Mission Corp., 212 F.2d 77 (2d Cir.), cert. denied, 347 U.S. 1016 (1954), illustrates that maintenance of the same position alone is not sufficient to avoid liability.

110. 212 F.2d at 86. "As a matter of fact it seems quite possible that no one of the factors we have enumerated, standing alone, would be sufficient for that result. But in cumulative effect we think they are. The reclassification at bar could not possibly lend itself to the speculation encompassed by § 16(b). This being so, it was not a 'purchase' and the decision below was correct." Id.

Thus, the Second Circuit Court of Appeals distinguished previous cases[111] in which the acquired securities were of a pre-existing class, were publicly held, and had an independent value in a pre-existing market.[112] It should be noted that, in not finding a "purchase," the court necessarily held two factors to be non-determinative: that effective, although not majority, control of the corporation was in the hands of the defendants,[113] and that the reclassification was effected for the defendant's benefit rather than that of the corporation. Thus, one can feel relatively safe even with such circumstances existing so long as no other possibility of abuse exists.[114]

The court, relying on the cumulative effect of the above three factors, did not indicate which factor alone might be decisive in a future case and refused to formulate a firm rule. However, the failure to enunciate a "black-letter rubric" once again leaves the well-intentioned insider in a precarious position. A reclassification of stock conceivably may constitute a "purchase," and possibily even a "sale."[115] Thus, one must keep in mind the underlying question to which the courts will address themselves: is the transaction likely to lend itself to abuse by insiders?

111. See note 112 infra.

112. Id. at 83-84, citing Blau v. Mission Corp., 212 F.2d 77 (2d Cir.), cert. denied, 347 U.S. 1016 (1954); Park & Tilford, Inc. v. Schulte, 160 F.2d 984 (2d Cir.), cert. denied, 332 U.S. 761 (1947); Blau v. Hodgkinson, 100 F. Supp. 361 (S.D.N.Y. 1951); Truncale v. Blumberg, 80 F. Supp. 387 (S.D.N.Y. 1948). These factors enabled the court to distinguish the instant case from the leading case of Park & Tilford, Inc. v. Schulte, 160 F.2d 984 (2d Cir.), cert. denied, 332 U.S. 761 (1947), where, although the alternatives of sale, redemption, or conversion were open to all stockholders, the defendants could have used inside information in choosing among them.

113. Compare Park & Tilford, Inc. v. Schulte, 160 F.2d 984, 988 (2d Cir.), cert. denied, 332 U.S. 761 (1947) with Shaw v. Dreyfus, 172 F.2d 140 (2d Cir.), cert. denied, 337 U.S. 907 (1949). In Roberts, the defendant's control was minimally considered because the proposed classification required a two-thirds vote of the outstanding shares. 212 F.2d at 83. What the result would have been if the defendant had owned two-thirds or more, and had thus been able to approve reclassification, is left to conjecture. However, since the three determinative factors would still exist, and the degree of control was held non-determinative in Roberts, it would seem that such an insider would not be liable.

114. In Marquette Cement Mfg. Co. v. Andreas, 239 F. Supp. 962, 966 (S.D.N.Y. 1965), the court distinguished Roberts in holding that a liquidation after a sale of assets for stock involved a "purchase." In Marquette, the court observed that there was no guarantee of equal treatment for all stockholders, and, since the sale of assets resulted in the holding of stock of a different issuer, the defendants did not retain the same interest in the plaintiff corporation.

115. See Cole, Insiders' Liabilities Under the Securities Exchange Act of 1934, 12 Sw. L.J. 147, 165 (1958).

B. *Mergers*

1. In General

Even though rule 16b-9,[116] exempting the conversion of one convertible equity security into another, now makes such transactions of little danger to the insider, it has appropriately been said that "the conversion cases, like the forms of action that have been abolished, may continue to rule us from their graves."[117]

In order to act intelligently and lawfully, every insider should be aware that two contradictory approaches, developed by the courts to deal specifically with conversions, are now being followed in deciding whether insiders must disgorge their profits when their corporations merge.[118]

One approach—the "objective" approach—which reads the statute literally, would find liable every defendant who acquires and disposes of

116. Rule 16b-9 provides in part:

"(a) Any acquisition or disposition of an equity security involved in the conversion of an equity security which, by its terms or pursuant to the terms of the corporate charter . . . , is convertible immediately or after a stated period of time into another equity security of the same issuer, shall be exempt from the operations of section 16(b) of the Act: Provided, however, That this section shall not apply to the extent that there shall have been either (1) a purchase of any equity security of the class convertible (including any acquisition of or change in a conversion privilege) and a sale of any equity security of the class issuable upon conversion, or (2) a sale of any equity security of the class convertible and any purchase of any equity security issuable upon conversion (otherwise than in a transaction involved in such conversion or in a transaction exempted by any other rule under Section 16(b)) within a period of less than six months which includes the date of conversion.

(b) For the purpose of this section, an equity security shall not be deemed to be acquired or disposed of upon conversion of an equity security if the terms of the equity security converted require the payment or entail the receipt, in connection with such conversion, of cash or other property (other than equity securities involved in the conversion) equal in value at the time of conversion to more than 15 percent of the value of the equity security issued upon conversion." 17 C.F.R. §§ 240.16b-9(a),(b) (1974). Professor Loss points out that "[t]he exemption is not unconditional. When the 15 percent test is not met, or when there has been a pair of matching transactions within the proviso, the question is still open whether the conversion involved a 'purchase' or 'sale' quite apart from the exemption." 5 Loss 3028 (Supp. 1969).

117. 5 Loss 3029 (Supp. 1969).

118. These two approaches have been much analyzed by commentators. See, e.g., Bateman, The Pragmatic Interpretation of Section 16(b) and the Need for Clarification, 45 St. John's L. Rev. 772 (1971); Gadsby & Treadway, Recent Developments Under Section 16(b) of the Securities Exchange Act of 1934, 17 N.Y.L.F. 687 (1971). For a comprehensive analysis of the conversion cases, see Hamilton, Convertible Securities and Section 16(b): The End of an Era, 44 Texas L. Rev. 1447 (1966). See also Lowenfels, Section 16(b): A New Trend in Regulating Insider Trading, 54 Cornell L. Rev. 45 (1968); Comment, Section 16(b): An Alternative Approach to the Six-Month Limitation Period, 20 U.C.L.A.L. Rev. 1289 (1973).

stock in the merged corporation within six months if he is an officer, director, or beneficial owner.[119] The other approach—the "pragmatic" approach—interprets the statute in light of its congressional purpose. A court adopting this approach would require the insider to give up his profits only when it determines that his market activity was that which Congress intended to discourage.[120]

It is the "pragmatic" approach which makes difficult the task of advising the insider whether or not to purchase or sell within six months of a merger. Thus, it would seem appropriate to examine the more common section 16(b) problems which the insider faces with his corporation's merger or attempted merger.[121]

2. The Unsuccessful Tender Offeror

The unsuccessful tender offeror finds itself in a dilemma. Its significant investment position in a target company is of little use when the company has merged defensively with a third corporation in order to make its acquisition by the tender offeror impossible. Thus, the unsuccessful tender offeror may either exchange its shares in the target company for those of the corporation surviving the defensive merger, or it may sell its shares to a third party. Either way, if this transaction occurs within six months of its initial purchase, the tender offeror could be held liable.[122] Initially, it was thought that liability, under such circumstances,

119. See, e.g., Heli-Coil Corp. v. Webster, 352 F.2d 156 (3d Cir. 1965); Park & Tilford, Inc. v. Schulte, 160 F.2d 984 (2d Cir.), cert. denied, 332 U.S. 761 (1947).

120. See, e.g., Blau v. Lamb, 363 F.2d 507 (2d Cir. 1966), cert. denied, 385 U.S. 1002 (1967); Blau v. Max Factor & Co., 342 F.2d 304 (9th Cir.), cert. denied, 382 U.S. 892 (1965); Ferraiolo v. Newman, 259 F.2d 342 (6th Cir. 1958), cert. denied, 359 U.S. 927 (1959).

121. There have been a number of articles which have examined the application of § 16(b) to mergers and acquisitions. See Hemmer, Insider Liability for Short-Swing Profits Pursuant to Mergers and Related Transactions, 22 Vand. L. Rev. 1101 (1969); Lang & Katz, Section 16(b) and "Extraordinary" Transactions: Corporate Reorganizations and Stock Options, 49 Notre Dame Law. 705 (1974); Lang & Katz, Liability for "Short Swing" Trading in Corporate Reorganizations, 20 Sw. L.J. 472 (1966); Comment, Reliance Electric, Occidental Petroleum, and Section 16(b): Interpretative Quandary over Mergers, 51 Texas L. Rev. 89 (1972); Comment, Stock Exchanges Pursuant to Corporate Consolidation: A Section 16(b) "Purchase or Sale"?, 117 U. Pa. L. Rev. 1034 (1969). The theme which runs through these articles is a simple one indeed—the two approaches referred to above have made virtually impossible the task of predicting future actions by the courts in this area.

122. That a corporation, as an unsuccessful tender offeror, could be held liable simply by exchanging its stock in a disappearing corporation for that of the surviving corporation is made clear by the congressional definition of sale found in the 1934 Act. "When used in this chapter, unless the context otherwise requires . . . [t]he terms 'sale' and 'sell' each include any contract to sell or otherwise dispose of." 15 U.S.C. § 78c(a)(14) (1970). Furthermore, courts have held that the sale occurs, not when the corporation physically exchanges

was inevitable for the defeated tender offeror.[123] But in *Reliance Electric Co. v. Emerson Electric Co.*,[124] the Supreme Court recently limited such an offeror's liability to its sale of that portion of stock in the target company which brought its holdings below ten percent, leaving the disposal of its remaining interest unaffected by the provisions of section 16(b).

The reaction of the legal community to this decision was mixed. The SEC criticized it on the ground that a judicially created exception to section 16(b) was unnecessary.[125] One writer prematurely interpreted the decision as the reestablishment by the Court of the "objective" approach mentioned earlier.[126] The significance of *Reliance* lies neither in its utilization of a mechanical formula nor in its creation of a limited exemption for the trapped tender offeror. Instead, *Reliance* simply is an example of modern judicial interpretation of section 16(b).[127] When such a defendant is not in a position to use inside information, modern courts have been more reluctant to force him to give up his profits. But these courts by no means have given the tender offeror "carte blanche" to ignore the statute. Trapped tender offerors which have substantial investments in the equity securities of the target company, and therefore are less able to absorb even limited liability, are hardly benefitted by the *Reliance* decision. These defendants, unlike Emerson which purchased only a 13 percent interest in its target company, find themselves owners of 20 to 40 percent of the stock in the disappearing corporation. Thus, even if they follow the *Reliance* two-sale formula, they lose most of

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its shares, but when its rights and obligations become fixed. See, e.g., Blau v. Ogsbury, 210 F.2d 426, 427 (2d Cir. 1954).

123. See American Standard, Inc. v. Crane Co., 346 F. Supp. 1153 (S.D.N.Y. 1972); cf. Hemmer, Insider Liability for Short-Swing Profits Pursuant to Mergers and Related Transactions, 22 Vand. L. Rev. 1101, 1110-15 (1969).

124. 404 U.S. 418 (1972). Professor Loss first recommended this two-step sale approach. 2 Loss 1060. In fact, Justice Stewart found such action to be as legitimate as a preconceived plan spacing every sale six months and one day between each purchase. 404 U.S. at 423.

125. Analysis: Reliance Electric—The Problem with Section 16(b), BNA Sec. Reg. L. Rep. No. 140, at B-5 (Feb. 23, 1972). The SEC even prepared an amendment to the Act which specifically included the two-step sale within the ambits of § 16(b). SEC Proposals to Implement Recommendations of "Unsafe" and "Unsound" Report, BNA Sec. Reg. L. Rep. No. 135, at A-4 (Jan. 19, 1972).

126. Note, Reliance Electric and 16(b) Litigation: A Return to the Objective Approach?, 58 Va. L. Rev. 907 (1972).

127. The Reliance Court observed that "[i]n interpreting the terms 'purchase' and 'sale,' courts have properly asked whether the particular type of transaction involved is one that gives rise to speculative abuse." 404 U.S. at 424 n.4. See The Supreme Court, 1972 Term, 87 Harv. L. Rev. 57, 295 (1973); 15 B.C. Ind. & Com. L. Rev. 149, 159-62 (1973).

their profits. But, if they attempt to retain control of their stock, the closing of the defensive merger (a section 16(b) sale) within six months of the defendant's purchase exposes them to liability.[128] Furthermore, by retaining control of these shares, such defendants often find themselves in conflict with the anti-trust laws.[129] Although one might expect such a defendant to meet with a sympathetic reception from the courts, such is not always the case. For example, in *American Standard, Inc. v. Crane Co.*,[130] not even the fact that the target company had engaged in activity proscribed by rule 10b-5 absolved the tender offeror of section 16(b) liability.[131] The *Crane* court reasoned that tender offerors invariably win control of the soon-to-disappear corporation, or sell the stock acquired in the unsuccessful venture at a handsome profit,[132] and that such tender offerors, by controlling the timing of their offers (and the amount offered to stockholders for their shares), could have a substantial effect on the ultimate terms of the defensive merger.[133] The court, therefore, found a possibility of speculative abuse in such transactions and found the defendant liable.[134]

The fact that the target company forced the tender offeror to sell its shares by threatening to sue on anti-trust grounds has also failed to deter modern courts from finding trapped tender offerors liable under the section. In *Allis-Chalmers Manufacturing Co. v. Gulf & Western Industries, Inc.*,[135] the corporate plaintiff not only made this threat, but also cut its dividends by 50 percent in order to drive away the unwanted tender offeror. In finding the defendant liable, the court refused to take these factors into consideration.[136]

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128. See Comment, Stock Exchanges Pursuant to Corporate Consolidation: A Section 16(b) "Purchase or Sale"?, 117 U. Pa. L. Rev. 1034, 1060-61. The student writer suggested that all such situations be the subject of a new § 16(b) exemption.

129. See, e.g., Allis-Chalmers Mfg. Co. v. Gulf & W. Indus., Inc., 372 F. Supp. 570 (N.D. Ill. 1974).

130. 346 F. Supp. 1153 (S.D.N.Y. 1971).

131. The tender offer failed, not as the result of honest competition between the parties, but because the plaintiff painted the tape (manipulated the price) in the stock of the disappearing company. Id. at 1156.

132. Id. at 1161.

133. Id.

134. Id.

135. 372 F. Supp. 570 (N.D. Ill. 1974). It should be noted here that G&W engaged in a substantial number of transactions which its chief executive refused to deny were consummated for speculative reasons. Id. at 578 & n.2. The fact that the transaction at issue may well have been the result of speculative investment could explain the court's finding of liability.

136. Id. at 579.

On the other hand, in *Kern County Land Co. v. Occidental Petroleum Corp.*,[137] the Supreme Court recently found a similarly situated tender offeror not liable. In so doing, the Court developed a two-pronged test for section 16(b) liability in the unorthodox transaction: the insider must have access to inside information, coupled with the existence of circumstances giving rise to the possibility of its abuse.[138] Applying this test both to an option given the surviving corporation by the tender offeror (callable six months and one day after the tender offer), and to the closing of the defensive merger, Justice White stated:

> [It is] totally unrealistic to assume or infer from the facts before us that Occidental either had or was likely to have access to inside information . . . so as to afford it an opportunity to reap speculative, short-swing profits from its disposition within six months of its tender-offer purchases.[139]

The decision in *Kern County* is equitable on its facts. Even after the tender offeror had become an insider, far from having access to inside information in the target company, it was frustrated at every turn in its attempt to gain information necessary to bring about a successful conclusion to its tender offer.[140] Furthermore, the Court recognized the involuntary nature of the exchange[141] and that the defendant had not participated in the negotiations surrounding the defensive merger precipitated by its tender offer.[142]

Lest the insider jump to unwarranted conclusions, it must be pointed out that *Kern County* may well not be the ultimate word spoken by the Supreme Court on section 16(b) liability of the tender offeror. After all, in *Reliance*, the Court adopted what seemed to be an "objective" approach to the law,[143] while in *Kern County*, the Court applied a highly subjective test.[144] The impression one is left with is that the courts still are struggling to develop an equitable standard in applying the statute.

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137. 411 U.S. 582 (1973).

138. Id. at 600.

139. Id. at 596.

140. Id. at 598-99. As the Court pointed out, "[r]equests by Occidental for inspection of Old Kern records were sufficiently frustrated by Old Kern's management to force Occidental to litigate to secure the information it desired." Id.

141. "Once agreement between those two companies crystalized, the course of subsequent events was out of Occidental's hands." Id. at 599.

142. "Occidental obviously did not participate in or control the negotiations or the agreement between Old Kern and Tenneco." Id.

143. See notes 124-28 supra and accompanying text.

144. See notes 137-42 supra and accompanying text.

3. The Successfully Merged Corporation

Many otherwise carefully drafted mergers or acquisitions have left huge section 16(b) liabilities in their wakes. Typically, these transactions are completely controlled by one of the merging corporations, create clear opportunities for speculative activities, and arouse the suspicion of the courts.[145] For these reasons courts initially interpreted the statute strictly, finding liability whenever one of the merging corporations acquired and disposed of stock within six months.[146] Although one court subsequently refused to hold a corporation liable for a "mere transfer between corporate pockets"[147]—the exchange took place between a parent and its wholly-owned subsidiary—a recent decision, *Newmark v. RKO General, Inc.*,[148] has established that in virtually all other contexts a purchase or sale of merger-related securities by a controlling corporation, when consummated within six months of a merger, will result in the almost automatic forfeiture of any profits earned in the transactions. RKO, which controlled Frontier Corporation through ownership of 56 percent of Frontier's stock, agreed to merge Frontier with Central Airlines. In order to ensure its dominant position in the survivor, RKO contracted to purchase a majority of Central's stock. The purchase (conditioned upon so many factors that in effect RKO could call the deal off if it so desired)[149] was matched by the court with the equally optional merger (in which RKO exchanged the Central shares for those of the newly formed corporation)[150] and RKO was forced to surrender its profits. The court's determination was grounded upon RKO's position throughout the merger. Since it could decide whether and when the merger would take place "[t]he purchase and merger agreements placed [the defendant] in a position which must be the dream of every speculator—'Heads I win, tails I do not lose.' "[151]

RKO could have avoided this result had it bought Central's shares outright six months and one day before the merger. Alternatively, RKO could have refrained from taking a position in Central and purchased

145. The possibility that a corporation could abuse inside information gained through a merger has long been recognized. See Cook & Feldman 626.

146. Stella v. Graham-Paige Motors Corp., 132 F. Supp. 100 (S.D.N.Y. 1955), modified, 232 F.2d 299 (2d Cir.), cert. denied, 352 U.S. 831 (1956); cf. Morales v. Colt Indus., Inc., [1972-1973 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 93,569 (S.D.N.Y. 1972).

147. Blau v. Mission Corp., 212 F.2d 77 (2d Cir.), cert. denied, 347 U.S. 1016 (1954).

148. 425 F.2d 348 (2d Cir.), cert. denied, 400 U.S. 854 (1970), noted in 84 Harv. L. Rev. 1012 (1971).

149. 425 F.2d at 353-54.

150. Id.

151. Id. at 354.

shares in the newly formed corporation after the merger was effected. Thus, *Newmark* stands as an object lesson to the insider. The corporation controlling a merger must limit its purchases and sales to the period of time not covered by the statute. Any other course of action, however, advantageous in terms of control, will be equally disadvantageous in terms of section 16(b).

4. The Individual Insider

Legal scholars have long been aware that the officer, director or beneficial owner who purchases and sells the securities of his merging corporation is often privy to inside information.[152] Thus, he is in an excellent position to take advantage of such information at the expense of the investing public, which is exactly what section 16(b) was designed to prevent.[153] However, it is clear that ignorance of the consequences of their actions, rather than the desire to benefit unjustly from inside information, accounts for a significant portion of the litigation in this area.

In the landmark decision of *Blau v. Hodgkinson*,[154] three insiders who sold securities within six months of a corporate simplification (where a subsidiary was "blended" with its parent) were forced to give up their profits. They clearly had not considered the exchange of the securities of the subsidiary for those of the parent to be a section 16(b) purchase.[155] In *Marquette Cement Manufacturing Co. v. Andreas*,[156] the principal stockholder of a merging corporation was found liable for his sale of the securities of the surviving corporation within six months of

152. See Cook & Feldman 626. See also Comment, Stock Exchanges Pursuant to Corporate Consolidation: A Section 16(b) "Purchase or Sale"?, 117 U. Pa. L. Rev. 1034, 1045-46 (1969) [hereinafter cited as Comment].

153. "The [individual] insider [in an exchange of stock in the disappearing corporation for that of the survivor] cannot control, though he may be able to influence, the acquiring corporation's entry into the transaction. But in this respect he is in at least as good a position as the purchaser for cash, who cannot control the seller's decision to sell. The crucial factor is that in both cases the insider has information about what he is acquiring which gives him an unfair advantage over his outsider competitors in the market place, in negotiating the transaction and deciding whether to complete it. [Therefore] there is a possibility of short-swing speculation through the use of inside information not disclosed to the public at the time of the initial transaction." Comment 1045-46.

154. 100 F. Supp. 361 (S.D.N.Y. 1951).

155. The court observed: "When the defendants turned over their stock in [the] subsidiary and received stock [in the parent], they received something totally different from that which they surrendered—stock in a different corporation [the parent] with assets acquired from all four subsidiaries subject to the liabilities of all four subsidiaries." Id. at 373.

156. 239 F. Supp. 962 (S.D.N.Y. 1965).

the merger. Not only was his own exchange of shares pursuant to the merger found to be a section 16(b) purchase, but the court also indicated that, since he had accepted the position of director in the new corporation before the merger, his own corporation might have been held liable for having deputized him had the plaintiff been able to make out a slightly better case.[157]

Nor have former owners of closed corporations, who have used such devices as the contingent stock payout plan to sell their assets to a larger corporation, been exempted from the effects of the statute. In *Booth v. Varian Associates*,[158] two such defendants agreed to accept shares of stock of the acquiring corporation as the last installment of the purchase price for their close corporation. As in most plans of this kind, the number of shares received depended upon the market performance of the acquiring company's securities.[159] The defendants were found liable even though the contract had been made three years before they sold the shares which they received pursuant to it. Because the defendants were uncertain as to how many shares they would receive until the date of delivery stipulated by the original agreement, the court found the purchase to have occurred when they received the shares rather than when they had agreed to receive them.[160]

More recent decisions involving individual insiders have not been more sympathetic toward such defendants. In fact, the use of the "pragmatic approach" by some modern courts has expanded the scope of section 16(b) liability rather than limit it. For instance, in *Champion Home Builders Co. v. Jeffress*,[161] the court found that a controlling shareholder who had shepherded his corporation to a successful merger, had "purchased" shares in the survivor, not when the merged corporation's board

157. Id. at 967. See Shattuck Denn Mining Corp. v. La Morte, [1973-1974 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 94,429, at 95,473 (S.D.N.Y. Mar. 8, 1974). The possibility that a deputization may occur during a merger was also recognized in a recent law review article. Comment, Latest Developments in the Tax Treatment of Private Annuity Transactions, 47 Texas L. Rev. 1395, 1435 (1969). For a general discussion of the deputization problem, see notes 10-19 supra and accompanying text.

158. 334 F.2d 1 (1st Cir. 1964), cert. denied, 379 U.S. 961 (1965), noted in 12 U.C.L.A.L. Rev. 1471 (1965).

159. The contingent stock payout plan has been defined as a "device used in corporate acquisitions by which the ratio of the exchange of stock is determined in part by the future earnings of the acquired corporation." Comment, Section 16(b): An Alternative Approach to the Six-Month Limitation Period, 20 U.C.L.A.L. Rev. 1289, 1300-01 (1973).

160. The court offered this explanation: "Although the agreement [of 1959] firmly committed both parties to an eventual exchange of shares, . . . it [left] the purchase price unfixed, . . . thus making the purchase under the contract as much as possible like a market purchase at the time of the closing." 334 F.2d at 4 (emphasis omitted).

161. 490 F.2d 611 (6th Cir.), cert. denied, 94 S. Ct. 2390 (1974).

of directors approved the merger, but when the formal agreement was signed three months later.[162] The lower court had reasoned that director-approval alone fixes the rights of the parties in situations such as these.[163]

Furthermore, in *Schur v. Salzman*,[164] the court forced another insider who had purchased shares of his own corporation within six months of a merger, to disgorge the profit he had earned by selling "control" shares to the acquiring company.

These cases resemble one another in that the defendants actively participated in the negotiations leading up to the merger. But in a recent decision, *Gold v. Sloan*,[165] one court refused to penalize a director who sold securities less than six months after his company merged into a larger corporation. There, the court adopted this approach even though the defendant had been named a director of the surviving corporation. In the same decision, the court held that a second director, who had also sold shares within six months of the merger, was forced to surrender any profits realized from the transaction. The distinction was that the first director had been locked out of the pre-merger negotiations, behind which the second director had been the moving force. Thus, the second director's access to inside information (gained from his participation in the negotiations), and the possibility that he could have abused it, determined the court's action.[166] On the other hand, the first director had

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162. Accord, Kern County Land Co. v. Occidental Petroleum Co., 411 U.S. 582, 596 (1973).

"On August 30, 1967, the Old Kern-Tenneco merger agreement was signed, and Occidental became irrevocably entitled to exchange its shares of Old Kern stock for shares of Tenneco preference stock." Query, did not the insider's rights become fixed upon approval by the boards of directors rather than the formal ceremony?

163. 352 F. Supp. 1081 (E.D. Mich. 1973), rev'd, 490 F.2d 611 (6th Cir.), cert. denied, 94 S. Ct. 2390 (1974). The lower court observed that "[s]ince this was merely a purchase of stock by Champion, all that was needed to bind the corporation to the deal was the approval of the Board of Directors." Id. at 1083. This observation seemingly accords with those decisions holding that beneficial ownership occurs when the rights and obligations of the parties become fixed. See, e.g., Stella v. Graham-Paige Motors Corp., 232 F.2d 299 (2d Cir.), cert. denied, 352 U.S. 831 (1956).

164. 365 F. Supp. 725 (S.D.N.Y. 1973). Two writers, commenting upon the applicability of the section to control premiums, recently remarked; "[c]ontrol premiums may or may not be proper when a controlling block of stock is purchased and sold within six months . . . ." Gadsby & Treadway, Recent Developments Under Section 16(b) of the Securities Exchange Act of 1934, 17 N.Y.L.F. 687, 713 (1971).

165. 486 F.2d 340 (4th Cir. 1973), petition for cert. filed sub nom. Gold v. Scurlock, 42 U.S.L.W. 3623 (U.S. Apr. 30, 1974) (No. 73-1638), discussed in Note, Securities Exchange Act Section 16(b): Fourth Circuit Harvests Some Kernels of Gold, 42 Fordham L. Rev. 852, 871-76 (1974).

166. 486 F.2d at 352-53.

received only the same information available to anyone who read the prospectus.[167]

It should be recognized that *Gold* offers no simple formula to the insider who wishes to avoid section 16(b) merger problems.[168] Only one course of action can guarantee just that. If one acquires shares during a merger, he must refrain from any sales for at least six months. Furthermore, purchases should be limited to a period at least six months prior to the closing of the merger. Only this procedure will prevent a loss of profits otherwise lawfully earned though such activity.

V. The Measure of Liability

Section 16(b) provides that "any profit realized" from short swing transactions shall inure to the issuer.[169] However, because neither the Act nor the SEC has offered a comprehensive definition of "profit realized," its meaning has become the subject of judicial interpretation. In so responding, the courts again look to the underlying purposes of the statute.[170] The Court of Appeals for the Second Circuit stated the underlying premise in *Smolowe v. Delendo Corp.*:[171]

> [T]he statute was intended to be thorough-going, to squeeze all possible profits out of stock transactions, and thus to establish a standard so high as to prevent any conflict between the selfish interest of a fiduciary officer, director, or stockholder and the faithful performance of his duty.[172]

This severity is evidenced by the rule developed for computation of profits—"lowest price in, highest price out."[173] Basically, the method

167. Id. at 344-51.

168. The Gold decision has been criticized severely for its failure to look to the post-merger period in its determination of liability. Note, Securities Exchange Act, Section 16(b): Fourth Circuit Harvests Some Kernels of Gold, 42 Fordham L. Rev. 852, 876 (1974). Also, query whether the director's right to have inside information, ignored by the Gold court, makes the distinction drawn between directors by that court somewhat dubious. The result appears to emasculate the operation of § 16(b).

169. 15 U.S.C. § 78p(b) (1970).

170. Thus, such obvious methods of computation as "average cost" and "first in, first out" have been rejected because of their susceptibility to evasion of complete divestment of profit. See Cook & Feldman 612-13; Meeker & Cooney, The Problem of Definition in Determining Insider Liabilities Under Section 16(b), 45 Va. L. Rev. 949, 954-55 (1959); Rubin & Feldman 481-82.

171. 136 F.2d 231 (2d Cir.), cert. denied, 320 U.S. 751 (1943).

172. Id. at 239.

173. Id. This rule was reaffirmed in Gratz v. Claughton, 187 F.2d 46, 51 (2d Cir.), cert. denied, 341 U.S. 920 (1951). See also Feder v. Martin Marietta Corp., 406 F.2d 260, 269 (2d Cir. 1969), cert. denied, 396 U.S. 1036 (1970); Adler v. Klawans, 267 F.2d 840, 847-48

involves substracting the lowest purchase price from the highest sales price of the transaction subject to liability, then the next lowest price from the second highest sale price, and so on, until all securities have been accounted for. The differences resulting are then totalled, with the sum signifying the recoverable "profit realized,"[174] with no provision for offsetting losses against profits.[175]

It should be realized, however, that as a result of the prohibition against offsetting losses, the general rule may result in a recovery by the corporation even though the insider has suffered a net loss.[176] In one case,[177] the defendant had to return profits of about $300,000 even

(2d Cir. 1959); Arkansas Louisiana Gas Co. v. W.R. Stephens Inv. Co., 141 F. Supp. 841, 847 (W.D. Ark. 1956). For critiques of the Smolowe formula, see Munter, Section 16(b) of the Securities Exchange Act of 1934: An Alternative to "Burning Down the Barn in Order to Kill the Rats," 52 Cornell L.Q. 69, 81-85, 99-100 (1966) [hereinafter cited as Munter]; Painter, The Evolving Role of Section 16(b), 62 Mich. L. Rev. 649, 650-58 (1964).

174. The application of the text may best be illustrated by a hypothetical (assume figures are for one share):

Date	Purchase Price	Date	Sale Price
5/1	10	5/15	12
6/1	20	6/15	23
7/1	35	7/15	40
8/1	40	8/15	45
	105		120

The "profit realized" is not $15. The insider, according to the "lowest in, highest out" rule, would forfeit $55 [(45 — 10) + (40 — 20)]. Had the insider dealt with 1,000 shares, he would have been liable for $55,000!

175. Smolowe v. Delendo Corp., 136 F.2d 231, 239 (2d Cir.), cert. denied, 320 U.S. 751 (1943). Even where it is difficult to accurately compute the defendant's profits, except that they fall between a maximum and minimum limit, "and when the uncertainty arises from the defendant's wrong, the upper limit will be taken as [the measure of profits realized]." Gratz v. Claughton, 187 F.2d 46, 51-52 (2d Cir.), cert. denied, 341 U.S. 920 (1951) (footnote omitted).

176. For example:

Date	Purchase Price	Date	Sale Price
5/1	10	5/15	12
6/1	20	6/15	23
7/1	35	7/15	40
8/1	40	8/15	10
	105		85

Although the insider had a net loss of $20, the recoverable profit here would be $33 [(40 — 10) + (23 — 20)], or $33,000 if the insider traded 1,000 shares.

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

though his trading actually resulted in a $400,000 loss.[178] In fact, profits may be recovered even if one has suffered a net loss on each transaction.[179] In such cases, the method seemingly incorporates a punitive aspect into the statute,[180] attempting to gain the maximum deterrence against future violations.[181] It is well established, nonetheless, that the insider must surrender net profits only, so that at least commissions and transfer taxes incident to the transaction may be deducted.[182] Similarly, an insider is entitled to an allowance for expenses, but only for those actually incurred.[183]

178. The loss of $400,000 is referred to by the court in Adler v. Klawans, 267 F.2d 840, 847-48 (2d Cir. 1959).

179. For example:

Date	Purchase Price	Date	Sale Price
5/1	40	5/15	35
6/1	30	6/15	25
7/1	20	7/15	15
8/1	10	8/15	5
	100		80

Although the insider lost $5 on each transaction, he would still be liable for profits of $30 [(35 — 10) + (25 — 20)], or $30,000 if he dealt in 1,000 shares.

180. See Munter 83-84; Painter, The Evolving Role of Section 16(b), 62 Mich. L. Rev. 649, 657 (1964).

181. The courts strive to apply the statute in order to best effectuate its purpose. For example, in Blau v. Mission Corp., 212 F.2d 77 (2d Cir.), cert. denied, 347 U.S. 1016 (1954), where an exchange of stock was found to constitute a § 16(b) sale rather than a purchase, the court determined the sale price in accordance with the market value of the stock received. Thus, with respect to profit-making transactions, it seems that the courts will determine purchase price by looking to the consideration parted with, whereas if the exchange involves a sale, the consideration received would be determinative. See also Lewis v. Nadaline, [1973-1974 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 94,587 (S.D.N.Y. June 4, 1974); Fistel v. Christman, 135 F. Supp. 830 (S.D.N.Y. 1955). If the consideration given "is not another security with a readily ascertainable market value, the market price of the security in question is some evidence of value." Lewis v. Nadaline, supra at 96,056. Accord, B.T. Babbitt, Inc. v. Lachner, 332 F.2d 255, 258 (2d Cir. 1964).

182. Falco v. Donner Foundation, Inc., [1952-1956 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 90,612 (S.D.N.Y.), rev'd on other grounds, 208 F.2d 600 (2d Cir. 1953).

183. Blau v. Mission Corp., 212 F.2d 77, 82 (2d Cir.), cert. denied, 347 U.S. 1016 (1954). For example, when the transactions occupied one-fourth of the time of the defendant's employees during the period in question, the court deducted one-fourth of the following expenses: general overhead, office rent, office salaries and supplies, automobile expenses, postage, telephone, teletype and telegraph. Arkansas Louisiana Gas Co. v. W.R. Stephens Inv. Co., 141 F. Supp. 841, 847 (W.D. Ark. 1956). The consistent employment of such a liberal rule in the future has been doubted. See Cole, Insiders' Liabilities Under the Securities Exchange Act of 1934, 12 Sw. L.J. 147, 169 (1958). The same court, in fact, disallowed

Are dividends recoverable? In a "sale and purchase" transaction, the defendant is permitted to deduct from his profit the dividends that he would have received if he had kept the stock throughout the interim.[184] However, in "purchase and sale" transactions, the answer is not as clear-cut. If the dividends are declared before the defendant becomes an insider, they are not recoverable by the corporation.[185] On the other hand, if the dividends are declared and paid while the defendant is an insider, they are recoverable.[186] If the dividend is declared while the defendant is an insider, but the securities are sold by him at a loss which is greater than the amount of the dividends, then the dividends are not recoverable.[187] However, it should be kept in mind that:

> Situations may well arise relative to dividends where they are so inextricably connected with the "purchase and sale" of stock and possible manipulation by insiders for their own benefit and to the detriment of the corporation and the investing public as to compel the formulation of a rule on the subject under discussion in order to prevent the frustration of the statutory purpose . . . .[188]

Although seemingly harsh, the results are not only harmonious with the objective to "squeeze all possible profits out of stock transactions"[189] but aid in making unattractive any inclination to participate in short-swing transactions.[190]

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deductions for the salesmen's salaries, since no sales campaign was used in selling the stock, and there were no travel and entertainment expenses. 141 F. Supp. at 847.

184. Falco v. Donner Foundation, Inc., [1952-1956 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 90,612 (S.D.N.Y.), rev'd on other grounds, 208 F.2d 600 (2d Cir. 1953).

185. Adler v. Klawans, 267 F.2d 840, 848 (2d Cir. 1959). "This is not inconsistent with our primary holding that a director need not be such both at the time of purchase and time of sale of stock in order to be accountable under Section 16(b). Our primary holding simply gives effect to the statutory mandate which presupposes that, at some moment before making a sale of stock, the insider was in an official position which he could have used to influence the sale price." Id. (emphasis deleted).

186. Western Auto Supply Co. v. Gamble-Skogmo, Inc., 348 F.2d 736, 744 (8th Cir. 1965), cert. denied, 382 U.S. 987 (1966). See also Marquette Cement Mfg. Co. v. Andreas, 239 F. Supp. 962, 968 (S.D.N.Y. 1965). This reasoning has not been limited to cash dividends. Thus, "when a purchase or sale that precedes a stock dividend (or stock split) is to be matched against a sale or a purchase made after the record date for the dividend distribution (or the split) there should be a proportionate adjustment in the price per share of the stock obtained or disposed of in the earlier transaction in order to determine the true measure of profit realized, if any, in the later transaction." Blau v. Lamb, 363 F.2d 507, 527 (2d Cir. 1966), cert. denied, 385 U.S. 1002 (1967).

187. Adler v. Klawans, 267 F.2d 840, 849 (2d Cir. 1959). See also Kabansky v. Emerson Radio & Phono. Corp., 184 F. Supp. 90, 94 (S.D.N.Y. 1960).

188. Adler v. Klawans, 267 F.2d 840, 849 (2d Cir. 1959) (footnote omitted).

189. Smolowe v. Delendo Corp., 136 F.2d 231, 239 (2d Cir.), cert. denied, 320 U.S. 751 (1943).

190. As observed by Judge Learned Hand in Gratz v. Claughton, 187 F.2d 46, 52 (2d

Although most cases have awarded the recovery of interest,[191] such recovery is within the court's discretion, [192] and will be "denied when its exaction would be inequitable."[193]

Defendants found liable under section 16(b), however, will not be liable for the plaintiff corporation's attorney's fees. A stockholder who brings suit to recover the insider's profits is entitled to an award of attorney's fees,[194] but the source of this remuneration is not the insider

Cir.), cert. denied, 341 U.S. 920 (1951): "The crushing liabilities which § 16(b) may impose . . . should certainly serve as a warning, and may prove a deterrent."

191. See, e.g., B.T. Babbitt, Inc. v. Lachner, 332 F.2d 255, 258 (2d Cir. 1964); Stella v. Graham-Paige Motors Corp., 232 F.2d 299, 302 n.4 (2d Cir.), cert. denied, 352 U.S. 831 (1956); Magida v. Continental Can Co., 231 F.2d 843, 848 (2d Cir.), cert. denied, 351 U.S. 972 (1956); Blau v. Mission Corp., 212 F.2d 77, 82 (2d Cir.), cert. denied, 347 U.S. 1016 (1954); Pappas v. Moss, 257 F. Supp. 345, 368 (D.N.J. 1966), rev'd on other grounds, 393 F.2d 865 (3d Cir. 1968); Adler v. Klawans, 172 F. Supp. 502, 506 (S.D.N.Y. 1958), aff'd, 267 F.2d 840 (2d Cir. 1959). It is important to note that such a result is more likely than not to occur for two reasons. First, the courts realize that the use of the money by the insider is of benefit to him from the time he realizes the profit until he is forced to relinquish it. Secondly, the allowance of interest is seemingly required in order to comply with the Smolowe doctrine of squeezing out all possible profits. Regardless, the courts continue to consider the equities of the particular case. See, e.g., Western Auto Supply Co. v. Gamble-Skogmo, Inc., 348 F.2d 736, 744 (8th Cir. 1965), cert. denied, 382 U.S. 987 (1966).

192. This interest has not been awarded upon the showing of good faith on the part of the defendant. See, e.g., Gold v. Sloan, 486 F.2d 340, 353 (4th Cir. 1973), petition for cert. filed sub nom. Gold v. Scurlock, 42 U.S.L.W. 3623 (U.S. Apr. 30, 1974); Lewis v. Wells, 325 F. Supp. 382, 387 (S.D.N.Y. 1971); Volk v. Zlotoff, 318 F. Supp. 864, 867 (S.D.N.Y. 1970); Blau v. Lamb, 242 F. Supp. 151, 161 (S.D.N.Y. 1965), aff'd in part, rev'd in part, 363 F.2d 507, 528 (2d Cir. 1966), cert. denied, 385 U.S. 1002 (1967); Marquette Cement Mfg. Co. v. Andreas, 239 F. Supp. 962, 968 (S.D.N.Y. 1965). However, lack of knowledge of the law has been found to be an insufficient basis for denying interest, even where the defendant "had at least colorable grounds for contesting liability." Blau v. Kraus, [1967-1969 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 92,205, at 96,952 (S.D.N.Y. 1968). Some cases have denied the recovery of interest without stating a reason. See, e.g., Chemical Fund, Inc. v. Xerox Corp., [1964-1966 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 91,653, at 95,419 (W.D.N.Y. 1966), rev'd on other grounds, 377 F.2d 107 (2d Cir. 1967).

193. Blau v. Lehman, 368 U.S. 403, 414 (1962), quoting Board of Comm'rs v. United States, 308 U.S. 343, 352 (1939). See also Magida v. Continental Can Co., 231 F.2d 843, 848 (2d Cir.), cert. denied, 351 U.S. 972 (1956); Adler v. Klawans, 172 F. Supp. 502, 506 (S.D.N.Y. 1958), aff'd, 267 F.2d 840 (2d Cir. 1959). There is one decision holding that the defendant show some "overriding inequity" in order to disallow interest since a full accounting ordinarily allows the recovery of such interest. Perfect Photo, Inc. v. Grabb, 205 F. Supp. 569, 573-74 (E.D. Pa. 1962). In another case, since the defendant was entitled to the exemption softening "the burden on long-term holders of stock options," it was termed inequitable to exact interest. Morales v. Walt Disney Prods., [1973 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 94,199, at 94,855 (S.D.N.Y. 1973).

194. Bernstein v. Kennelly, 433 F.2d 10 (9th Cir. 1970) (per curiam); Smolowe v. Delendo Corp., 136 F.2d 231, 241 (2d Cir.), cert. denied, 320 U.S. 751 (1943); Newmark

—rather, the funds recovered by the corporation.[195] This approach is based on the theory that the corporation which has received the benefit of the attorney's services should pay their value. Thus, reimbursement is contingent upon the success of the corporation in recovering the short-swing profits.[196] Similarly, allowances have been granted to a stockholder who obtains an increased judgment for the corporation by intervening in a suit brought by the corporation,[197] or who recovers the short-swing profits on behalf of the corporation by compromise agreement before the suit reaches trial.[198] In other words, the courts realize that the interest of attorneys in seeking clients and fees[199] may often be the stimulus to the enforcement of section 16(b) claims.[200]

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v. RKO Gen., Inc., 332 F. Supp. 161, 163-64 (S.D.N.Y. 1971); Berkwich v. Mencher, 239 F. Supp. 792, 794 (S.D.N.Y. 1965); Magida v. Continental Can Co., 176 F. Supp. 781, 783 (S.D.N.Y. 1956), aff'd, 231 F.2d 843 (2d Cir.), cert. denied, 351 U.S. 972 (1956); Steinberg v. Sharpe, 95 F. Supp. 32, 34 (S.D.N.Y. 1950), aff'd, 190 F.2d 82 (2d Cir. 1951) (per curiam); 2 Loss 1052.

195. Smolowe v. Delendo Corp., 136 F.2d 231, 241 (2d Cir.), cert. denied, 320 U.S. 751 (1943); Henss v. Schneider, 132 F. Supp. 60, 63 (S.D.N.Y. 1955).

196. Henss v. Schneider, 132 F. Supp. 60, 63 (S.D.N.Y. 1955). See also Fistel v. Christman, 133 F. Supp. 300, 304 (S.D.N.Y. 1955). If an investigation by the stockholder's attorney reveals no wrongdoing on the part of the insider, it follows that neither the stockholder nor his attorney is entitled to reimbursement for legal expenses. See, e.g., Blau v. Kraus, [1967-1969 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 92,205 (S.D.N.Y. 1968). However, if the corporation recovers the short-swing profits as a result of the investigation, reimbursement is clearly appropriate. Dottenheim v. Emerson Elec. Mfg. Co., 77 F. Supp. 306 (E.D.N.Y. 1948).

197. Park & Tilford, Inc. v. Schulte, 160 F.2d 984, 988-89 (2d Cir.), cert. denied, 332 U.S. 761 (1947).

198. Blau v. Berkey & Berkey Photo, Inc., [1967-1969 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 92,264 (S.D.N.Y. 1968); Blau v. Brown & W. Nuclear, Inc., [1967-1969 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 92,263 (S.D.N.Y. 1968); Blau v. Allen, 171 F. Supp. 669, 671 (S.D.N.Y. 1959).

199. Section 16(b) provides for a two year statute of limitations for the recovery of short-swing profits in a suit by the corporation, permitting a stockholder to bring suit only if the corporation fails or refuses to sue within sixty days after request or fails to prosecute such suit diligently. 15 U.S.C. § 78p(b) (1970). Therefore, upon discovery of a § 16(b) violation, a potential plaintiff must give the corporation notice and then wait sixty days before initiating his individual action. If the corporation settles after the individual plaintiff files suit, counsel fees are recoverable, although the reasonableness of the fee may be reviewed on appeal. See Blau v. Allen, 171 F. Supp. 669 (S.D.N.Y. 1959). If the corporation settles or files suit within the sixty day period, one would expect a request for counsel fees to be denied. However, the courts have refused to establish a policy of denying recovery in such instances. See, e.g., Blau v. Berkey & Berkey Photo, Inc., [1967-1969 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 92,264 (S.D.N.Y. 1968); Globus, Inc. v. Jaroff, 279 F. Supp. 807 (S.D.N.Y. 1968).

The Court of Appeals for the Second Circuit has limited the recovery of counsel fees,

VI. Tax Consequences

The realization of insider profits proscribed by section 16(b) has federal income tax consequences affecting both the insider who returns his profits and the corporation which receives the repayment. It is settled that the repayment is taxable income for the corporation.[201] The insider's profits are taxable to the insider upon receipt, although he may take a deduction when repayment is made to the corporation.[202] The only question is whether the repayment is deductible as an ordinary or capital loss.

The Internal Revenue Service has contended that the tax treatment of the realized profits should characterize the tax effect of the subsequent repayment.[203] However, the Tax Court has twice permitted an ordinary business deduction,[204] based on its failure to discover "a sufficient nexus to require the conclusion that the later transaction was so integrally related to the earlier transaction . . . ."[205] The courts of appeals reversed both decisions and, in effect, agreed with the IRS.[206]

Probably, a general rule should be adopted directing that the tax treatment of the repayment is to be governed by the tax treatment of the

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where the corporation has settled or filed suit during the sixty day period by the application of the "substantial period" test. Blau v. Rayette-Faberge, Inc., 389 F.2d 469, 473 (2d Cir. 1968). Under that test, when a stockholder's attorney seeks to recover for a complaint drafted during the statutory period, compensation will be granted only where the corporation has been given notice near the end of the two year statute of limitations and the corporation's inaction is likely to continue. Gilson v. Chock Full O'Nuts Corp., 331 F.2d 107 (2d Cir. 1964). Similarly, where a stockholder's attorney seeks to recover for the investigation and discovery of a short-swing transaction during the period, and where the corporation thereafter filed suit or settled, compensation "will be allowed only if the corporation has done nothing for a substantial period of time after the suspect transactions and its inaction is likely to continue." Blau v. Rayette-Faberge, Inc., 389 F.2d 469, 473 (2d Cir. 1968).

200. See, Smolowe v. Delendo Corp., 136 F.2d 231, 241 (2d Cir.), cert. denied, 320 U.S. 751 (1943); Magida v. Continental Can Co., 176 F. Supp. 781, 783 (S.D.N.Y.), aff'd 231 F.2d 843 (2d Cir.), cert. denied, 351 U.S. 972 (1956); 2 Loss 1051-55.

201. General Am. Inv. Co. v. Commissioner, 348 U.S. 434, 436 (1955); Park & Tilford Distillers Corp. v. United States, 107 F. Supp. 941, 942 (Ct. Cl. 1952), cert. denied, 345 U.S. 917 (1953); 53 Colum. L. Rev. 565 (1953); 66 Harv. L. Rev. 1318 (1953); 54 Mich. L. Rev. 151 (1955).

202. Laurence M. Marks, 27 T.C. 464 (1956); accord, Joseph P. Pike, 44 T.C. 787 (1965). See Rev. Rul. 61-115, 1961-1 Cum. Bull. 46, revoking I.T. 4069, 1952-1 Cum. Bull. 28.

203. See William L. Mitchell, 52 T.C. 170, 175 (1969), rev'd, 428 F.2d 259 (6th Cir. 1970), cert. denied, 401 U.S. 909 (1971).

204. James E. Anderson, 56 T.C. 1370 (1971), rev'd, 480 F.2d 1304 (7th Cir. 1973); William L. Mitchell, 52 T.C. 170 (1969), rev'd, 428 F.2d 259 (6th Cir. 1970), cert. denied, 401 U.S. 909 (1971).

205. James E. Anderson, 56 T.C. 1370, 1376 (1971), rev'd, 480 F.2d 1304 (7th Cir. 1973).

206. See note 204 supra.

realized profit.[207] However, an ordinary and necessary business expense deduction possibly would be available to a taxpayer who voluntarily repays, without admission or adjudication of guilt, for the sole purpose of protecting his employment or business reputation, at least where he probably would not be found liable.[208] Although future rulings are difficult to predict, one can be confident that primary consideration will be given to the fact that section 16(b) seeks "to place the insider in the same position he would have occupied if he had never engaged in the stock dealings . . . ."[209]

VII. CONCLUSION

The determining factor running through most of the cases that have been decided under section 16(b) is whether there exists the *possibility* of the use of inside information to the enrichment of the insider. However, the courts have not been consistent in the application of this underlying yardstick. A striking example is the division of the Supreme Court in *Reliance* and in *Kern County*, the two most recent cases before that Court. In *Reliance*, as we have seen, a plan admittedly designed to avoid the impact of the statute received the approval of a majority of the Court. In *Kern County*, decided only a year ago, the Supreme Court again was divided in ruling against liability in a tender offer-defensive merger situation. It is interesting to note that in *Kern County* Justice Stewart, who wrote the majority opinion in *Reliance*, joined Justice Douglas who dissented in both cases.

And so, after forty years, the debate between the "objective" and "subjective," or "pragmatic," approaches goes on. Where then does this leave the insider—of good intent or otherwise?

In sum, the corporate insider undertakes at his peril any course of action that even remotely could activate section 16(b). The only safe course for him is to refrain from buying and selling any equity security

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207. But see Lokken, Tax Significance of Payments in Satisfaction of Liabilities Arising Under Section 16(b) of the Securities Exchange Act of 1934, 4 Ga. L. Rev. 298, 321 (1970).

208. See James E. Anderson, 56 T.C. at 1375. The court also drew support for its position by analogizing the Anderson situation to cases dealing with the deduction of payments made under guarantees of corporate indebtedness by stockholders (see J. Meredith Siple, 54 T.C. 1 (1970)), and cases dealing with loans to a corporation by its stockholder-employees. Compare Niblock v. Commissioner, 417 F.2d 1185 (7th Cir. 1969) with Trent v. Commissioner, 291 F.2d 669 (2d Cir. 1961). These cases held that if a taxpayer can prove that the loans were made because of his desire to protect his status as an employee, rather than his status as a stockbroker, then he is entitled to a business bad debt deduction.

209. 5 Loss 3048 (Supp. 1969).

of the issuer, or from pursuing any action from which a purchase or sale can be construed, within a period of six months.

Except in typical situations, there is no sure way of predicting that an insider will escape the ubiquitousness of section 16(b) of the Securities Exchange Act. Is that what Congress intended?