Securites Exchange Act Section 16(b): Fourth Circuit Harvests Some Kernels of Gold

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SECURITIES EXCHANGE ACT SECTION 16(b):
FOURTH CIRCUIT HARVESTS SOME
KERNELS OF GOLD

As expressed in a legislative hearing prior to its enactment, section 16(b) of the Securities Exchange Act of 1934 was intended "to protect the interests of the public against the predatory operations of directors, officers, and principal stockholders of corporations by preventing them from speculating in the stock of the corporations to which they owe a fiduciary duty." Although the section does not prohibit this sort of trading, it permits the issuer (or a shareholder on its

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1. 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). See also sources cited in note 24 infra. For an interesting account of the financial abuses during the chaotic period prior to this section's passage see F. Pecora, Wall Street Under Oath (1939). Section 16(b) drastically altered the common law under which insiders generally were permitted to enrich themselves by trading on inside information. See H. Manne, Insider Trading and the Stock Market 17-26 (1966) [hereinafter cited as Manne]; Cook & Feldman, Insider Trading Under the Securities Exchange Act, 66 Harv. L. Rev. 385, 408-10 (1953). For a comparison of § 16(b) and the common law see Yourd, Trading in Securities by Directors, Officers and Stockholders: Section 16 of the Securities Exchange Act, 38 Mich. L. Rev. 133, 139-52 (1939).

The abuses revealed by the congressional investigations were striking and many prominent members of the financial community believed that these sure-thing profits were merely part of the emolument of their office. 10 SEC Ann. Rep. 50 (1944). Moreover it has been demonstrated that the lure of insider trading presented no less a problem in the last decade than it did during the twenties. Baunhart, How Ethical are Businessmen?, 39 Harv. Bus. Rev. 6 (Jul.-Aug. 1961). Although most take the view that insider trading is detrimental to the operation of the market, some have concluded that there are advantages in allowing this sort of speculation. Manne 131-45; Hetherington, Insider Trading and the Logic of the Law, 1967 Wis. L. Rev. 720. While it has been observed that in theory insider trading could benefit the market in the economic sense, Wu, An Economist Looks at Section 16 of the Securities Exchange Act of 1934. 68 Colum. L. Rev. 260 (1968), Mr. Manne's views have been sharply criticized. Schotland, Unsafe at Any Price: A Reply to Manne, Insider Trading and the Stock Market, 53 Va. L. Rev. 1425 (1967); Mendelson, Book Review, 117 U. Pa. L. Rev. 470 (1969).

2. Section 16(b) of the Securities Exchange Act of 1934 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 . . . 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. . . . 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." 15 U.S.C. § 78p(b) (1970).

behalf\(^4\) to recover all profits received by statutory insiders\(^6\) from any purchase and sale or sale and purchase of the issuer’s equity securities within a six-month period,\(^6\) without proof of actual use or intent to use inside information.\(^7\) Since the plaintiff need only prove purchase and sale, it would seem to follow that recoveries should be more or less automatic. However, the most troublesome questions facing the courts, particularly in the “unorthodox” transaction, have

4. After a merger, for example, any shareholder of the surviving corporation has standing to sue an insider of the acquired corporation to recover, for the survivor, profits garnered from transactions in the acquired corporation’s stock while that corporation was alive. See Western Auto Supply Co. v. Gamble-Skogmo, Inc., 348 F.2d 736, 741 (8th Cir. 1965), cert. denied, 382 U.S. 987 (1966); Blau v. Oppenheim, 250 F. Supp. 881 (S.D.N.Y. 1966). A shareholder has standing even though the securities were purchased after the disputed transactions took place, Magida v. Continental Can Co., 231 F.2d 843, 847 (2d Cir.), cert. denied, 351 U.S. 972 (1956), or even though the plaintiff owned a miniscule interest such as two shares, Pellegrino v. Nesbit, 203 F.2d 463, 466 (9th Cir. 1953). The shareholder must, however, prior to the commencement of his suit, make a demand on the corporation that it institute an action to recover the profits. 15 U.S.C. § 78p(b) (1970).

5. The term “insider” usually is understood to mean any person who is a director or officer of the issuer of any equity security which is registered or any person or entity who is either directly or indirectly the beneficial owner of more than 10 percent of any class of such equity security. See generally 15 U.S.C. § 78p(a) (1970); Meeker & Cooney, The Problem of Definition in Determining Insider Liabilities Under Section 16(b), 45 Va. L. Rev. 949 (1959) [hereinafter cited as Meeker & Cooney]. However, there have been controversies over the scope of these categories. Where there is proof of deputization a principal, such as a partnership or a corporation, may be held liable as a director. Feder v. Martin Marietta Corp., 406 F.2d 260, 263 (2d Cir. 1969), cert. denied, 396 U.S. 1036 (1970); see Blau v. Lehman, 368 U.S. 403 (1962). One would also be considered a 10 percent owner of an issuer if the percentage of the issuer’s equity securities into which a convertible debenture could be exchanged would equal 10 percent or more. Chemical Fund, Inc. v. Xerox Corp., 377 F.2d 107, 111-12 (2d Cir. 1967); see 15 U.S.C. § 78c(a)(11) (1970). This rule has been applied even where the convertible is not registered. Simon v. Sunasco, Inc., [1969-70 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 92,547 (S.D.N.Y. 1970); accord, Gold v. Scurlock, 324 F. Supp. 1211, 1215-16 (E.D. Va. 1971), modified sub nom. 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. 73-1638). See also Perfect Photo, Inc. v. Grabb, 205 F. Supp. 569, 572 (E.D. Pa. 1962) (§ 16(b) only requires registration at time of sale). See notes 113 & 114 infra for a discussion of “officers” under § 16(b).

6. The six-month trading limitation presumably was placed in the section because it was believed that normal market fluctuations would probably eliminate any profit gained through a short swing transaction during this period and because Congress did not wish to discourage unduly bona fide long-term investment. Blau v. Max Factor & Co., 342 F.2d 304, 307-08 (9th Cir.), cert. denied, 382 U.S. 892 (1965), and sources cited therein. See also Comment, Section 16(b): An Alternative Approach to the Six-Month Limitation Period, 20 U.C.L.A. L. Rev. 1289, 1294-1300 (1973).


8. Unorthodox transactions are those non-cash transactions which do not fit neatly into categories of purchase or sale. 2 L. Loss, Securities Regulation 1069 (2d ed. 1961). The term has been used in connection with various types of transactions. See, e.g., Kern County Land
been the determinations of whether the requisite purchase and sale have taken place. Within the framework of a merger, the determination frequently centers on an exchange of securities. The question presented is whether this exchange should be considered a purchase or a sale as those terms are defined by the Act.\(^9\)

As a practical matter, this analysis in turn is dependent upon the time frame through which a court views the particular transaction.

A recent case—*Gold v. Sloan*\(^{10}\)—reflects the problem. There, plaintiff, a shareholder of Susquehanna Corporation, brought suit under section 16(b) to compel defendants, five Susquehanna insiders, to return profits allegedly realized in conjunction with a merger between Susquehanna and the Atlantic Research Corporation. According to the terms of the merger agreement, the defendants, who had been insiders of Atlantic, assumed insider positions in Susquehanna and received the latter's preferred securities for their Atlantic common stock in the exchange accompanying the merger. Within six months thereafter, shares of the preferred were sold.

Two defendants, Sloan and Scurlock, were directors and ten percent owners of Atlantic, but none of the defendants had purchased any Atlantic stock during the six-month period preceding the merger. Sloan was also the chief executive officer of Atlantic and later of Susquehanna, having exclusive control over the former's merger negotiations. The remaining defendants occupied lower man-

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The confusion created by these transactions prompted one commentator to conclude: “Mergers probably involve sales and purchases (but not necessarily); . . . Options probably are sales . . . (but not necessarily); . . . Control premiums may or may not be proper when a controlling block of stock is purchased and sold within six months. . . . and . . . Hindsight is excellent for finding possibilities for abuse of inside information in the ‘unorthodox’ transaction.” Gadsby & Treadway, Recent Developments Under Section 16(b) of the Securities Exchange Act of 1934, 17 N.Y.L.F. 687, 713 (1971) (emphasis omitted) [hereinafter cited as Gadsby & Treadway].


agement positions in Atlantic and continued in similar capacities in Susquehanna.\textsuperscript{11}

The district court found a "potential for abuse" in the circumstances surrounding the merger and held that four of the defendants "purchased" the preferred securities when they were received in the exchange.\textsuperscript{12} Since a sale followed within six months, the four were ordered to return the profits made on this "short swing" transaction. The court of appeals, affirming in part and reversing in part, found that only Sloan had the opportunity to speculate on inside information. Though the court believed he had not abused his position, he was held liable under the section.\textsuperscript{13} In reaching this decision over a vigorous dissent, the majority adopted a novel position with respect to its investigation into possibilities for abuse. The only period deemed to have had any relevance in this inquiry was that preceding the transaction in question.\textsuperscript{14} Although, perhaps, this position could be justified by the trend of the current approach to section 16(b), the objections raised by the dissent highlight the inadequacies of this seemingly straightforward but latently complicated statute.

At the outset, it should be emphasized that in resolving the crucial section 16(b) inquiries,\textsuperscript{15} there is a shade of difference between saying that the transaction(s) need not be based on actual intent or use of inside information and saying that the transaction(s) need not \textit{possibly} have been based on inside information. The distinction is significant in two areas of the \textit{Gold} analysis. First, the distinction concerns the development of the current approach to section 16(b); since the trial and appellate decisions were separated by a significant judicial change in the interpretation of the section, the litigation provides a useful vehicle for assessing the nature of this change and its initial impact. Secondly, the distinction has a marked effect—in a context such as that presented in \textit{Gold}—where the unorthodox transaction represents the purchase by which one becomes an insider of the issuer. In this regard, the propriety of the court of appeals' investigation solely into pre-insider activities raises serious difficulties and represents a measurable deviation from prior case law.

\textsuperscript{11} Id. at 342. In addition, Sloan and Scurlock were directors of Susquehanna after the merger. Id. at 349.


\textsuperscript{14} Id. at 343.

\textsuperscript{15} See text accompanying notes 6-9 supra.
Perhaps the best chronological and substantive analysis of section 16(b) is obtained through an examination of the dual presumptions which underlie the operation of the section. First, there is a presumption of access to inside information which attaches once the individual or entity meets the statutory requirements for insider status. Secondly, there is a presumption of abuse in the sense that an insider who profits on a purchase and sale of his issuer's securities within the prescribed time limit is presumed to have traded on the basis of inside information. Though these presumptions are recognized as conclusive in the simple cash transaction, a dispute has arisen as to whether they are rebuttable in the borderline areas of purchase and sale.

Under what has been referred to as an "objective" approach, the earliest decisions interpreting the section did so as if both presumptions were conclusive. Focusing on the all-encompassing definitions of purchase and sale, section 16(b) liability was predicated on the objective record of facts alone, with little emphasis on the reason for the transaction or the way it was conducted. While this approach to the section was at least workable in the cash transaction, the results were often harsh. Furthermore, similar application of the section to more unorthodox transactions produced unsatisfactory results—if not purposeful.


17. "It is true enough that, in the case of a garden-variety purchase and sale or sale and purchase...the statute operates as a 'crude rule of thumb,' and that it would be no defense that a person within its terms was operating, by sheer intuition, from Antarctica or even from outer space." Abrams v. Occidental Petroleum Corp., 450 F.2d 157, 162 (2d Cir. 1971) (footnote omitted), aff'd sub nom. Kern County Land Co. v. Occidental Petroleum Corp., 411 U.S. 582 (1973).

18. See Smolowe v. Delendo Corp., 136 F.2d 231 (2d Cir.), cert. denied, 320 U.S. 751 (1943). The frequently cited "high water mark" of this approach was Park & Tilford, Inc. v. Schulte, 160 F.2d 984 (2d Cir.), cert. denied, 332 U.S. 761 (1947). There, in determining whether a conversion of preferred securities into common stock was a purchase of the common, the court stated: "Whatever doubt might otherwise exist as to whether a conversion is a 'purchase' is dispelled by definition of 'purchase' to include 'any contract to buy, purchase, or otherwise acquire.' Defendants did not own the common stock in question before they exercised their option to convert; they did afterward. Therefore they acquired the stock, within the meaning of the Act." Id. at 987 (citation omitted). This broad language, though perhaps justified by the facts of the case since the defendants controlled the corporation, suggested that every conversion or similar acquisition involved a § 16(b) purchase; it was interpreted in this manner. Heli-Coil Corp. v. Webster, 352 F.2d 156, 165-167 (3d Cir. 1965). The more recent decisions departed from the Park & Tilford approach to conversions. See note 28 infra. For a discussion of the objective approach and a collection of literature on the subject see Lowenfels, Section 16(b): A New Trend in Regulating Insider Trading, 54 Cornell L. Rev. 45, 46-50 & n.20 (1968) [hereinafter cited as Lowenfels].

19. One example of the unflinching application of the section was Western Auto Supply Co. v. Gamble-Skogmo, Inc., 348 F.2d 736 (8th Cir. 1965), cert. denied, 382 U.S. 987 (1966). Gamble had purchased 25,942 shares of its subsidiary at $32.35 per share and simultaneously placed these shares in its profit-sharing trust for the benefit of its employees. Within six months Gamble sold all its remaining shares in the subsidiary (over 1,200,000) for $36.00 per share. The eventual purchaser, through the acquired subsidiary, recovered over $94,000 from Gamble, representing the profit on the purchase and sale of 25,942 shares, despite the
less severity. Nevertheless, adherents of the objective approach, notably Justice Douglas, maintained that both presumptions were and should be considered conclusive. In the early stages of the section's development, however, there was a lack of viable alternatives for the section 16(b) litigant and it was not surprising that the section's penumbra was expanded to a point where it resembled more a general antifraud provision than a "crude rule of thumb."

The difficulty with the objective approach, however, at least with regard to the presumption of abuse is that neither the statute nor its legislative history demands such a rigid interpretation. In any case the dissatisfaction with that interpretation presaged the development of a more "pragmatic" application of the section, resulting in a thorough judicial reevaluation.

The newer approach enabled the courts to search the surrounding circumstances of unorthodox transactions to determine if they should be termed a purchase or sale. The Second Circuit cogently expressed the rationale behind this investigation in Blau v. Lamb:

fact that Gamble had divested itself of its interest in response to a government antitrust suit. Id. at 738-39.


21. Kern County Land Co. v. Occidental Petroleum Corp., 411 U.S. 582, 611 (1973) (Douglas, J., dissenting). Justice Douglas consistently has refused to narrow the scope of § 16(b) and has dissented in all three Supreme Court decisions involving the section. Compare his dissent in Kern with that in Reliance Elec. Co. v. Emerson Elec. Co., 404 U.S. 418, 442 (1972). See also Blau v. Lehman, 368 U.S. 403, 414 (1962) (Douglas, J., dissenting). In Reliance, Justice Douglas also advocated that a rebuttable presumption of abuse should attach to any subsequent dispositive transactions after an initial sale by a 10 percent owner if occurring within six months of the purchase. 404 U.S. at 438. Though he conceded that some might be caught unwittingly under such an "objective" construction, he maintained that the public and the investor are better served by the unrestricted operation of the section. 411 U.S. at 610.

22. Bateman, The Pragmatic Interpretation of Section 16(b) and the Need for Clarification, 45 St. John's L. Rev. 772, 778-79 (1971) [hereinafter cited as Bateman].

23. 5 Rev. of Sec. Reg. 982 (1972).

24. See Lowenfels 57-61; Comment, Mergers 97-99.

25. While the newer approach is often referred to as the subjective approach, the use of the word subjective implies that intent is involved in the determination of purchase and sale. Since this is not the case, courts and commentators have seemingly opted for the term "pragmatic" instead. Kern County Land Co. v. Occidental Petroleum Corp., 411 U.S. 582, 594-95 n.26 (1973); Bateman, supra note 22. Pragmatic will be utilized in this Note.


27. 363 F.2d 507 (2d Cir. 1966), cert. denied, 385 U. S. 1002 (1967).
The theory of regulation underlying Section 16(b)'s regulatory mechanism provides a sufficient reason for refusing to examine the details of transactions once it has been determined that they might possibly have served as vehicles for unfair insider trading. But it does not supply an equally sufficient reason for applying Section 16(b) in this same automatic fashion when a substantial question is raised whether a certain conversion transaction permits a possibility of insider abuse. Congress adopted the sweeping, arbitrary regulatory mechanism embodied in Section 16(b) in order to insure that even the possibility of insider abuse was deterred, but it would seem to follow that in order to avoid "purposeless harshness" a court should first inquire whether a given transaction could possibly tend to accomplish the practices Section 16(b) was designed to prevent.28

In the endeavor to resolve this issue the courts were really focusing on the presumption of abuse in that the insider's potential to abuse his position was the decisive factor.29 The presumption remained intact, however, since once this potential was found the transaction would be termed a purchase or sale and the insider presumed to have traded on inside information.30 If the transaction, when considered in the abstract or "objectively defined," afforded no such potential to him, then congressional purpose would not be served by applying the section.

Adherents of the older approach have criticized this development because they believe that much of the automatic and prophylactic effect of the section is lost by permitting these extended inquiries into the possibilities of abuse. This encourages the insider to engage in lengthy and expensive litigation by holding out the hope of escape, and the section becomes the antithesis of what Congress intended.31 Although at first glance these objections may appear valid, it has been commented that even under the pragmatic approach the automatic provision of

28. Id. at 519. See Blau v. Max Factor & Co., 342 F.2d 304, 307 (9th Cir.), cert. denied, 382 U.S. 892 (1969). These early decisions involved conversions of convertible securities. The confusion created by the decisions prompted the SEC to propose an amendment which would exempt almost all conversions from § 16(b) liability. This amendment, rule 16b-9, was adopted in 1966. 31 Fed. Reg. 3391 (1966), amending 17 C.F.R. § 240.16b-9 (1964). For an excellent discussion of the cases and the rule see Petteys v. Butler, 367 F.2d 528 (8th Cir. 1966), cert. denied, 385 U.S. 1006 (1967); Hamilton, Convertible Securities and Section 16(b): The End of an Era, 44 Texas L. Rev. 1447 (1966).

29. See notes 94-102 infra and accompanying text. Since the purpose behind the determination of abusive potential was to decide whether a § 16(b) purchase or sale had taken place, the section, hence the presumptions, should not have entered the inquiry until that decision was made. The definitions of purchase and sale, however, particularly as construed under the objective approach, easily included almost any transaction. See Kogan v. Schulte, 61 F. Supp. 604, 608 (S.D.N.Y. 1945) (purchase includes any mode of acquisition). Thus, the courts were faced at the outset of the determination with a sort of statutory presumption of purchase or sale which involved the presumptions of access and abuse.

30. "Frequently this initial inquiry will convince a court that the transaction in question held out at least the possibility of abuse; in such cases Section 16(b)'s regulatory mechanism requires that the section be applied without further inquiry." Blau v. Lamb, 363 F.2d 507, 519 (2d Cir. 1966), cert. denied, 385 U.S. 1002 (1967).

the section remains intact, since the approach merely envisions a classification or evaluation of the transaction irrespective of use or intent. If it is one of a class that could lead to insider speculation, then the statute is applied without reference to the facts of the specific case. Moreover, the history of the section has demonstrated the limited value of a mechanistic construction in a commercial environment of increasing complexity and in light of the courts' unwillingness to adhere to one. In addition, other developments in state and federal securities regulation have obviated the necessity for a catch-all construction that does not take cognizance of commercial reality and does not require proof of wrongdoing.

Gradually the circuits considering the issue accepted the pragmatic interpretation, but there remained confusion over its implementation. Since the courts were to be concerned solely with potential, not actual, abuse the parameters of the inquiry were significant. If the inquiry was too extensive the transaction would be defined too narrowly, approaching an inquiry into actual use of inside information which would abrogate any prophylactic effect of the section. On the other hand, if the inquiry were too restricted the transaction would be defined too broadly thus incorporating the disadvantages of the old approach and sterilizing the new. It was a delicate task and guidelines were formulated on an ad hoc basis.

The first pragmatic guidelines established with respect to mergers were formulated in *Newmark v. RKO General, Inc.* There, RKO, owning 56 percent of a subsidiary, negotiated an option with the subsidiary's proposed merger partner, Central Airlines, to purchase a controlling block of the latter's securities at a fixed price per share. This contract was signed after a provisional agreement to merge had been reached but before news of the merger was publicly disclosed or a formal agreement signed. "The significant factor [was] whether RKO could have reaped a speculative profit from the 'unfair use of information..."

32. George 1423.
33. Lowenfels 61-64; Comment, Mergers 99-100; Note, Reliance Electric 928-29. See notes 142-35 infra and accompanying text.
38. 425 F.2d at 351-52. In addition, there were other significant factors concerning the merger and purchase: RKO's subsidiary was given full access to Central's books and records, the Central shareholders were required to manage the corporation in a manner not unfavorable to RKO and the majority shareholders of both corporations were required to vote in favor of the merger. Further, if an expected subsidy from the Civil Aeronautics Board was inadequate, in RKO's judgment, or the CAB imposed prejudicial conditions on any of the parties, RKO had the right to withdraw from the agreement. The merger was also conditioned on the waiver of certain Central loan defaults by creditors. Id.
obtained ... by reason of [its] relationship to [Central]," and not whether RKO had in fact abused its position or intended to do so.

Upon investigation the court found a potential for speculation in the exchange between Central and the subsidiary chiefly on the basis of three factors: first, RKO had "acquired knowledge of what would transpire;" second, RKO had negotiated the terms and provisions of the option, including the purchase price, on the basis of this knowledge, yet before the public was aware of it; third, RKO could have exercised "substantial influence over the course of events." In short, the combination of these factors produced a situation which, as the court put it, "must be the dream of very speculator—'Heads I win, tails I do not lose.'" Consequently, RKO was held to have "purchased" the shares acquired from Central through the option and to have "sold" them when they were exchanged for the subsidiary's securities in the merger. Although the transactions were held to constitute a section 16(b) purchase and sale, it was clear that the court had refused to regard either as such a transaction per se, but instead had utilized the more flexible approach. In so doing, however, certain factors relied on by the court may have been outside the scope of section 16(b).

It must be emphasized that the issuer in the Newmark case was Central, not the subsidiary; RKO was held liable for the purchase and sale of the Central securities. Inasmuch as RKO did not occupy an insider position in Central until after the option was executed (at the earliest), it was clear that the initial and sole purchase by which RKO became an insider was sufficient to meet the statutory requirement of purchase. This aspect of the decision, taken alone, was not startling in spite of the section 16(b) provision which reads: "[t]his 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." Despite this straightforward language, in Stella v. Graham-Paige Motors Corp., the Second Circuit, adopting a trial court's analysis, previously had held that the initial purchase in such a situation would

39. Id. at 353 (quoting § 16(b)).
40. Id.
41. Id. at 354.
42. Id. at 353-54. The court could state with certainty that RKO had knowledge of what would transpire because RKO had participated in the merger negotiations.
43. Id. at 354. This situation was produced by the predictable market reaction to the news of the merger which would tend to drive the price of the securities upward. The market phenomenon was demonstrated sufficiently in the case in that the value of the subsidiary's shares received by RKO in exchange for the Central shares was almost twice what RKO had paid for them. Id. at 352, 355. The agreement was so structured that RKO would have been able to time the closing so as to make it coincide with the most favorable market price. If the expected rise in price did not occur, however, RKO could have refrained from purchasing. Id. at 353-54. For other reviews of this decision see Gadsby & Treadway 688-94; George 1423-26.
44. 425 F.2d at 354-55.
45. See note 2 supra.
suffice to bring the transaction within the scrutiny of section 16(b). The lower court reasoned that to hold otherwise would allow someone to purchase a large block of securities, sell to just under ten percent and then continually repeat the process. Thus, the statute should be construed as if it read "simultaneously with" the time of purchase. Since insiders are the only individuals presumed to have access to inside information, however, the only basis on which the decision could rest would be the presumed access in the post-purchase period. After the purchase both presumptions would be applicable. Although Stella involved only ten percent owners, the same reasoning was applied where a purchaser became a director and sold within six months. In that case, there was less


It has been observed, however, that it is unnecessary to interpret this part of the section in such a rigid manner. W. Painter, Federal Regulations of Insider Trading 39-42 (1968). In the hypothetical proposed by the court in Stella, it would logically follow that one who enjoyed insider status and then engaged in a sale and repurchase within six months could have done so on the basis of inside information and would fall within the ambit of the section. See Feder v. Martin Marietta Corp., 406 F.2d 260, 262 (2d Cir. 1969), cert. denied, 396 U.S. 1036 (1970); Schur v. Salzman, 365 F. Supp. 725, 728-29 (S.D.N.Y. 1973); cf. Reliance Elec. Co. v. Emerson Elec. Co., 404 U.S. 418, 422 (1972). The reverse situation presented by Stella and most mergers, however, does not hold true since only a sale could possibly have been based on inside information. It is worthy of note that in Stella the purchaser had been a 10 percent owner of the issuer for a considerable period prior to the alleged § 16(b) purchase. Three weeks before this transaction the issuer, by selling additional shares, had diluted the insider's ownership from 11.34 percent to 6.25 percent. 104 F. Supp. at 958. Thus, the transactions could very well have been initiated on expectations rooted in inside information. Due to the brief lapse of insider status, however, the court was not able to rest its decision on such access. This lapse of insider-issuer relationship was recently illustrated in Lewis v. Varnes, [Current Binder] CCH Fed. Sec. L. Rep. ¶ 94,343 (S.D.N.Y. Jan. 4, 1974), wherein a vice president and director had been given stock options that would have expired two months after his retirement. Two days after his resignation he exercised options which, when the securities received were sold, netted him a profit of nearly one-half million dollars for the six-months period. Id. at 95,158. Nevertheless, he was not held liable under § 16(b) since he had not been an insider at either end of the transaction. Id. See Levy v. Seaton, 358 F. Supp. 1 (S.D.N.Y. 1973).


inconsistency since the restrictive provision of the section only mentions beneficial owners. This post-purchase period was essential then, not simply as a method of getting around the statutory language, but as a period, often the only period, when the defendant could be presumed to have acted on the basis of inside information.

The Newmark decision was consistent with the Stella interpretation in that the court reasoned that RKO's presumed access to inside information resulting from its purchase provided an opportunity, not available to the investing public, to sell at the most advantageous moment. Nevertheless, in holding that RKO became a beneficial owner on the date the option was executed, the court distinguished Stella by stating:

*Stella* rested on the assumption that "one who holds an unexercised option is not usually in a position to obtain [advance] information from the company"... an assumption of no validity in the case before us. At the time it secured a conditional right to purchase Central securities, RKO was in possession of advance information of the type most likely to affect the price of Central shares—confidential knowledge of an impending merger... Yet it was clear that RKO had gained this advance information of the prospecive merger, absent any relationship to Central recognized by section 16(b). Undoubtedly RKO could have been held liable on the presumption of abuse attaching after the option was executed, but it was apparent that the key to the unfairness of the transaction was based on the information acquired through the relationship to the subsidiary. In addition, the abusive potential available to RKO after the option was executed also appeared to have its basis, not in any subsequent inside information which RKO could have presumably learned, but in the very structuring of the option so as to make it interdependent with the merger. As was mentioned, however, this structuring of the agreement was done on the basis of information already in RKO's possession. The predictable rise in the price of the securities—the key to the profit element in the transaction—need not have access to inside information in entering into his initial transaction. Having become an insider by virtue of becoming a director, it was this defendant's subsequent speculation that [was] the 'vice within the purview of § 16(b),'" Id. (citation omitted).

51. The courts also have noted that a director or officer is usually in a better position to influence the actions of his company and have more access to key information than 10 per cent owners. Adler v. Klawans, 267 F.2d 840, 845 (2d Cir. 1959).

52. 425 F.2d at 356.

53. Id. (citation omitted).

54. In addition, it would be possible to view RKO as an insider of Central after the provisional agreement was signed, but courts generally have looked to the point when rights become fixed. See Kern County Land Co. v. Occidental Petroleum Corp., 411 U.S. 582, 596 (1973) (the Court looked to the merger closing rather than the date of board approval); Champion Home Builders Co. v. Jeffress, 490 F.2d 611, 615-18 (6th Cir. 1974), petition for cert. filed sub nom. Jeffress v. Kramer, 42 U.S.L.W. 3585 (U.S. Apr. 4, 1974) (No. 73-1479). In Newmark, a guarantee of shareholder approval was only secured when the option was executed. 425 F.2d at 351.

55. See 84 Harv. L. Rev. 1012, 1018 (1971). The district court in Gold v. Scurlock also focused on this single aspect of the transaction. 324 F. Supp. at 1214 (citing Newmark).
was hardly a forecast which independently would concern section 16(b). Thus, in imposing liability under the section for the purchase and sale of the Central securities, information gained through pre-insider activities or relationships was the primary source of abuse; any reliance on the post-purchase aspects of the transaction was more shadow than substance. Nevertheless, the courts previously had focused on this area in merger situations to find sources of abuse while ostensibly predicating liability on presumed abuse after the purchase took place.

In Marquette Cement Manufacturing Co. v. Andreas, the defendants were held liable in somewhat analogous circumstances. There, the North American Cement Corporation (North American) dissolved pursuant to a sale of its assets to Marquette Cement Manufacturing Company (Marquette), receiving the latter's securities as payment. These securities were subsequently distributed to the shareholders and were sold within six months by the defendants. Defendant Andreas Corporation consisted of nineteen trusts holding all the stock of North American largely for members of the Andreas family. Defendant Andreas himself was the beneficiary of one of the trusts and sole trustee for the corporation but was not an officer or director. He was chairman of North American's board of directors until dissolution when he then was elected to the Marquette board.

In holding defendant Andreas personally liable for the purchase and sale of the Marquette securities, the court, relying on Stella and Adler v. Klawans, concluded that the receipt of this stock constituted a section 16(b) purchase. Thus, the post-purchase period was again emphasized in order to permit the application of the section. As in Newmark the defendant did not occupy a statutory insider's position in Marquette until after the purchase. It should have followed that any inside information gained through outside activities before the purchase would not concern the court. Nevertheless, it appeared as if the decision rested on the abusive potential which lay in the period surrounding the negotiations prior to the closing. The court found that this was not a case "where the stock of all shareholders [was] reclassified with some guarantee of equal treatment for all, but rather a case where a block of stock [was] acquired by a separate interest group at a price negotiated by them." Thus, while paying lip service to the "simultaneously with" approach, the court in fact scrutinized pre-insider activities of the defendants.

It is true that the statute addresses itself to the unfair use of inside information "which may have been obtained ... by reason of his [the insider's] relationship

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56. See notes 88-93 infra and accompanying text.
57. Also it could be maintained that RKO could have learned additional inside information about Central after the option was executed. But since the subsidiary had full access to the books and records of Central, it would appear that RKO would have learned any inside information through the subsidiary.
59. Id. at 965.
60. Id.
61. 267 F.2d 840 (2d Cir. 1959). See notes 50 & 51 supra and accompanying text.
62. 239 F. Supp. at 966.
63. Id.
to the issuer . . . .” At first glance it would appear that the activity complained of in Newmark and Marquette could come within the purview of section 16(b) by a liberal interpretation of this portion of the section. Clearly the defendants, while not insiders of the issuer whose stock was purchased and sold until after the purchase, abused their positions through their relationship to the issuer. In one of three Supreme Court decisions on section 16(b), however, the Court declined to apply such an interpretation despite its urging by the Securities and Exchange Commission. In Blau v. Lehman, an action was brought on behalf of a corporation to compel the return of profits allegedly realized by one of its directors and a partnership of which he was a member. It was claimed that the partnership had “deputed” the director to represent its interests on the corporation’s board of directors and, by virtue of the inside information learned through him, profited by trading in the corporation’s securities.

Under the deputization theory the SEC urged that the partnership be treated as a director; alternatively, it advocated that the partnership be held liable on policy grounds, since to hold otherwise would leave a “large and unintended” loophole in the statute. In rejecting the latter contention, the Court noted that “this very broadening of the categories of persons on whom these liabilities are imposed by the language of 16(b) was considered and rejected by Congress when it passed the Act.” Early drafts of the section would have made it unlawful for the specified class of insiders to disclose any confidential information regarding registered securities and “made all profits received by anyone, ‘insider’ or not, ‘to whom such unlawful disclosure’ had been made recoverable by the company.” These provisions were not adopted, however, even in the face of explicit judicial refusal to extend this aspect of the section. Thus, emphasis placed on

64. See note 2 supra (emphasis added).
65. 368 U.S. 403 (1962).
66. Id. at 405.
67. The Court agreed that the deputization theory was plausible but held that the facts of the case did not indicate that the director had, in fact, been deputized. Id. at 409. See Shattuck Denn Mining Corp. v. La Morte, [Current Binder] CHH Fed. Sec. L. Rep. ¶ 94,429, at 95,473 (S.D.N.Y. Mar. 8, 1974).
68. 368 U.S. at 410-13. The SEC argued that failure to hold the partnership liable would substantially eliminate the great Wall Street trading firm from the reach of § 16(b). Justice Douglas pointed out that Lehman Brothers had partners sitting on 100 boards. Id. at 414 (Douglas, J., dissenting).
69. Id. at 411-12 (opinion of Court).
70. Id. at 412.
71. Id. at 412-13.
actions taken or information received in non-insider capacities can be questioned seriously as approaching the standard for tippee liability under rule 10b-5.\[72\]

The two most recent Supreme Court decisions, Reliance Electric Co. v. Emerson Electric Co.\[73\] and Kern County Land Co. v. Occidental Petroleum Corp.,\[74\] lend some support to this proposition although both cases were primarily concerned with sales rather than purchases. In Reliance the question of purchase was not before the Court,\[75\] but a literal reading of the “both at the time of” provision of the section was utilized to exempt partially an unsuccessful tender offeror from section 16(b) liability. The offeror, having acquired a 13.2 percent interest in the target company, split its sales, reducing its holdings to 9.96 percent and then disposing of the remainder within two weeks.\[76\]

Justice Douglas, speaking for the dissenters,\[77\] maintained that there was a presumption of taint surrounding the transaction because “the 10% rule [was] based on a conclusive statutory presumption that ownership of this quantity of stock suffices to provide access to inside information.”\[78\] Thus, any transactions occurring within six months should be presumed to have been based on this access. In exempting the second sale, the majority agreed with Justice Douglas that it may be logical in such situations to presume that both transactions were based on inside information. But the Court held, in effect, that the defendant

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73. 404 U.S. 418 (1972).


75. The Court declined to decide the issue, 404 U.S. at 424, but the SEC had argued that there were three ways that insider abuses sought to be prevented by the statute could occur where the insider gains such status either simultaneously with or shortly after the initial purchase. First, the purchaser might obtain advance information prior to the purchase through negotiations for the purchase. The case would be the same for an officer or director who might obtain such information in negotiations prior to accepting the position. Second, one could purchase securities in a corporation in anticipation of engaging in manipulative practices which would raise the price of the stock. Third, one could obtain information or engage in manipulative activity after becoming an insider. Brief for SEC as Amicus Curiae at 22-25, Reliance Elec. Co. v. Emerson Elec. Co., 404 U.S. 418 (1972). Thus, the SEC viewed the purpose of the section in terms of preventing the misuse of inside information “regardless of whether obtained before or after the initial purchase.” Id. at 25. The implications of the Lehman decision, however, appear to exclude the first proposition wherein the prospective insider is really in a “tippee” position with respect to the issuer. The second basis of liability advanced by the SEC appears to concentrate on the mere intent of the prospective insider and not either the potential for abuse or even a conclusive presumption of abuse. By the terms of the statute itself intent is irrelevant in determining § 16(b) liability. Finally, the SEC’s third contention reflects the “simultaneously with” approach and of the three, represents the only legitimate concern to the court in this situation. Although the Court did not decide the issue, the court of appeals had relied on the post-purchase in holding that the initial acquisition was a § 16(b) purchase. 434 F.2d at 923-24.

76. 404 U.S. at 420.

77. Id. at 427-42.

78. Id. at 442.
must occupy a position designated by the statute before the presumption of use of information would operate.\textsuperscript{79} Since a two-week, .04 percent technicality immunized the second disposition, it was not a "sale" within the meaning of section 16(b). Such a strict attitude with regard to ten percent owners\textsuperscript{80} in this straight cash transaction indicated to many that the Court was signalling a return to the old approach to the section.\textsuperscript{81} That notion was dispelled, however, in Kern County Land Co. v. Occidental Petroleum Corp.\textsuperscript{82}

Occidental had acquired in excess of 20 percent of the outstanding common stock of Kern County Land Company (Old Kern) through two distinct tender offers.\textsuperscript{83} Even with this substantial interest, Occidental's efforts to reach a merger agreement with the Old Kern management were fruitless. Indeed, Old Kern vigorously restated the takeover attempt from the outset\textsuperscript{84} and subsequently announced that it had reached an agreement to merge with Tenneco, Inc. By the terms of this agreement, actually a sale of assets, Tenneco was to issue and exchange a new convertible preferred security valued at $105 per share for each outstanding share of Old Kern common. Occidental did not wish to maintain such a heavy position in a company in which it had not chosen to invest. Accordingly, an option was granted to New Kern—a subsidiary of Tenneco created to receive the Old Kern assets—to purchase all of the preferred securities to which Occidental would become entitled if and when the Kern-Tenneco merger took place.\textsuperscript{85}

\textsuperscript{79} Id. at 423-24.


\textsuperscript{81} E.g., Note, Reliance Electric, supra note 26, at 915. Such a conclusion was certainly justifiable since the Court, although noting that courts had looked to the possibilities of abuse in given transactions, 404 U.S. at 424 n.4, predicated its decision on an "objective measure of proof." Id. at 425, quoting Smolowe v. Delendo Corp., 136 F.2d 231, 235 (2d Cir.), cert. denied, 320 U.S. 751 (1943). The Court further stated, referring to Newark, that "[t]he Court of Appeals for the Second Circuit has held that an exchange of shares in one corporation for those of another pursuant to a merger agreement constitutes a 'sale' within the meaning of § 16(b)." 404 U.S. at 420 n.2. But the Reliance Court ignored the fact that the Newmark decision had been distinguished by the Second Circuit prior to Reliance in Abrams v. Occidental Petroleum Corp., 450 F.2d 157, 163 (2d Cir. 1971) (the Kern case), where it was specifically held that such an exchange may be a sale.

\textsuperscript{82} 411 U.S. 582 (1973).

\textsuperscript{83} On May 8, 1967, Occidental offered to purchase the first 500,000 shares tendered at $83.50 per share plus a brokerage fee. This represented an approximate $20 premium for the Kern securities. As of May 10, the desired number of shares had been tendered and Occidental became a 10 percent owner of Old Kern. On May 11, Occidental renewed its offer to purchase and on June 8, when the offer closed, Occidental owned 887,549 shares. Id. at 584-85 & n.5. For an interesting account of the Kern-Occidental battle see Rukeyser, Getting Tough With Tenders, Fortune, Aug., 1967, at 108.

\textsuperscript{84} The Kern management twice cautioned stockholders against tendering and even forced Occidental to litigate to secure minimal access to Old Kern's books and records, 411 U.S. at 585, 587 & n.12.

\textsuperscript{85} Id. at 587-88. Occidental also sought to obtain a ruling from the SEC which would have exempted the exchange of the Kern securities. The Commission declined to issue the
The option was to be exercisable six months and one day after the close of the tender offer.

The merger was closed within six months of the tender offer and Occidental was left with no alternative but to exchange the Kern common for the Tenneco preferred. The option was exercised according to its terms. 86 New Kern brought suit under section 16(b) to recover the considerable profits realized by Occidental claiming that either the execution of the option or the exchange should be considered a sale of the Kern securities. 87 It was contended that Occidental, knowledgeable in matters of corporate affairs and finance, had known that its takeover attempt would succeed or be confronted with a “defensive merger.” 88 In the latter case Occidental would have known that it could sell its stock to the merger partner at a substantial profit. It also was maintained that the execution of the option was a sale because the provisions of the agreement indicated that what was in form an option was in fact a sale.

The first allegation was quickly dismissed by the Court as irrelevant to any determination of liability under section 16(b):

Calculations of this sort, however, whether speculative or not and whether fair or unfair to other stockholders or to Old Kern, do not represent the kind of speculative abuse at which the statute is aimed, for they could not have been based on inside information obtained from substantial stockholdings that did not yet exist. 89

Parallels to the pre-insider forecasting in Newmark certainly can be drawn. Yet, in referring to that decision in another context the Court impliedly approved the holding. 90 In disposing of the second contention concerning the option, the Court noted that the option under discussion was a call which had characteristics, from the optionor's viewpoint, that would make speculation unlikely. 91

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86. Tenneco paid a $10 premium per share to secure the option which would have been forfeited if the merger had gone through and the option had not been exercised. The premium was credited toward the purchase price. Id. at 615 (Douglas, J., dissenting).

87. Id. at 590. The petitioner relied to a great extent on the mechanical application of the section in Reliance, see note 81 supra, and advocated the broad interpretation there given to Newmark. Brief for Petitioner at 34-37. Indeed, although both parties eventually developed both approaches, even the respondent felt constrained to frame its argument in terms of the “long-established objective test of § 16(b) . . . .” Brief for Respondent at 3.

88. 411 U.S. at 597. This is only one method available to incumbent management to defeat a tender offer. Id. at 597 n.29; see Kennedy, Defensive Take-over Procedures Since the Williams Act, 19 Catholic U.L. Rev. 158 (1970); Note, Defensive Tactics Employed by Incumbent Managements in Contesting Tender Offers, 21 Stan L. Rev. 1104 (1969). See also American Standard, Inc., v. Crane Co., 346 F. Supp. 1153 (S.D.N.Y. 1972) (defensive merger partner actively traded in the target company's stock thereby driving up the price and defeating the offer); Allis-Chalmers Mfg. Co. v. Gulf & W. Indus., Inc., [Current Binder] CCH Fed. Sec. L. Rep. ¶ 94,421, at 95,436 (N.D. Ill., Jan. 30, 1974) (target company cut its quarterly dividend in half, inducing the bidder to dispose of its interest).

89. 411 U.S. at 597.

90. Id. at 599.

91. Id. at 602. Occidental could not have forced Tenneco to purchase, but could not
addition, the Court emphasized that the option covered Tenneco preferred stock which was, as yet, unissued, unregistered and untraded.

It was the value of this stock that underlay the option and that determined whether the option would be exercised, whether Occidental would be able to profit from the exercise, and whether there was any real likelihood of the exploitation of inside information. If Occidental had inside information when it negotiated and signed the option agreement, it was inside information with respect to Old Kern. Whatever it may have known or expected as to the future value of Old Kern stock, Occidental had no ownership position in Tenneco giving it any actual or presumed insights into the future value of Tenneco stock. That was the critical item of intelligence if Occidental was to use the option for purposes of speculation.92

Occidental’s position vis-à-vis Old Kern and Tenneco was strikingly similar to RKO’s position in Newmark. The above quoted language, however, seems to indicate that (1) calculations such as a predictable rise in the price of securities which results when a merger is announced are not the calculations at which section 16(b) was aimed independent of a statutory insider position, and (2) even an insider position in one issuer is not sufficient for section 16(b) liability when the security involved is that of another issuer, despite the proximity between the two companies.93

It was true, of course, that in Newmark RKO acquired the call while Occidental sold the call, but the discrepancies should not have produced such disparate results. The only effect of the option in Newmark was to allow the Court to search into the post-purchase period for abusive potential. It would not have altered the fact that prior to the execution of the option RKO had no ownership have refused to sell if the option were exercised. Depending upon the market reaction to the new security either party could have benefited from the agreement. See generally 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); Comment, Put and Call Options Under Section 16 of the Securities Exchange Act, 69 Yale L.J. 868 (1960).

Essential to this distinction between positions in a call option was the Court’s determination that the option was an option both in form and in fact. In making this determination the Court accepted the conclusion reached by the court of appeals that the size of the premium (10 percent) had not been so large as to make the exercise of the option inevitable in view of the facts that: (1) experts had testified that the option was worth the premium paid; (2) there was a possibility that the market might drop in the following six months, and (3) the optionor had not surrendered its emoluments of ownership when the option was executed. 411 U.S. at 603-04. The case of Bershad v. McDonough, 428 F.2d 693 (7th Cir. 1970), cert. denied, 400 U.S. 992 (1971), was distinguished by the Court. There, the defendant, who had been an insider of Cudahy Co., executed a call option within six months of his becoming a 10 percent owner in Smelting Co. In holding that the execution of the option was a sale, the court stressed that the premium—14 percent of the purchase price—was forfeitable in the event the option was not exercised. In addition, the shares covered by the option were placed in escrow with the defendant’s attorney at the time the option was executed and an irrevocable proxy was given to the optionee to vote the shares at shareholder meetings. Finally, shortly after the option was executed, representatives of Smelting’s interests replaced the defendant and his associate on the Cudahy board. Id. at 698.

92. 411 U.S. at 602-03.
position in Central giving it any actual or presumed insights into the value of the Central shares; all it had was the knowledge of the merger and a predictable market reaction, neither of which should have concerned the Court since the former was not gained in an insider relationship to the issuer and the latter was a calculation, perhaps speculative and unfair, but not the evil at which section 16(b) was aimed. The additional fact of disclosure or the lack of it in Newmark would have had no effect on these aspects of the section.

The Kern decision also had further impact on the interpretation of the section inasmuch as a pragmatic approach to 16(b) was adopted. In determining that the exchange should not be considered a sale, the Court found that the involuntary nature of the transaction coupled with the lack of possibility of abuse precluded the application of the section. It was clear, however, that the “possibility of abuse” test applied by the Court included a serious discussion concerning opportunity for access to inside information, as well as the abusive potential in the transaction itself. This incorporation of an opportunity for access as an element in the pragmatic approach was a significant innovation, not only in terms of statutory construction but also in terms of the approach itself. As mentioned previously, the “potential for abuse” test which originated in the judicial retreat from an “objective” application of the section really focused on the presumption of abuse. Until Kern, however, the presumption of access attaching to the statutory insider remained sacrosanct. The abuse test had been more concerned with a determination of whether the transaction would afford the insider an opportunity to use the information he was presumed to possess. To

94. 411 U.S. at 594-95 n.26.
95. Id. at 600.
96. The Court found that it was “totally unrealistic to assume or infer from the facts... that Occidental either had or was likely to have access to inside information, by reason of its ownership of more than 10%... so as to afford it an opportunity to reap speculative, short-swing profits...” Id. at 596.
97. “There is, therefore, nothing...to indicate either the possibility of inside information being available to Occidental by virtue of its stock ownership or the potential for speculative abuse of such inside information by Occidental.” Id. at 599. See Supplemental Brief for the SEC as Amicus Curiae at 5-8, Gold v. Sloan, 486 F.2d 340 (4th Cir. 1973).
98. See B.T. Babbitt, Inc. v. Lachner, 332 F.2d 255 (2d Cir. 1964). “[E]ven absent proof that inside information was, in fact, used, the short-term profits... must be forfeited...” Id. at 257. The Kern decision has not jeopardized this aspect of the section’s application since there still need not be proof of actual access to inside information. The access test merely inquires into the possibilities of access to inside information. In the immediate aftermath of Kern however this was not recognized. See Selas Corp. of America v. Voogd, 365 F. Supp. 1268, 1271-72 (E.D. Pa. 1973). However, in Allis-Chalmers Mfg. Co. v. Gulf & W. Indus., Inc., [Current Binder] CCH Fed. Sec. L. Rep. ¶ 94,421 (N.D. Ill., Jan. 30, 1974), the unsuccessful bidder pleaded lack of inside information as an affirmative defense, but the court, citing both Kern and Gold, emphasized that the question was one of possibility rather than actuality. Id. at 95,436. Thus, application of § 16(b) turns on the possibilities of access and abuse and application is not automatically precluded because there was, in fact, no information to inside information. Id. at 95,435.
99. In Ferraiolo v. Newman, 259 F.2d 342 (6th Cir. 1958), cert. denied, 359 U.S. 927 (1959), the court went on to decide that the transaction, there a conversion, was of a kind
be sure, the discussions of abuse in the decisions gave some insight into the probability of access but there was a total lack of definitive language. Beyond a recognition of the presumption, the courts avoided any serious inquiry into the insider’s potential to gain access to inside information.\footnote{100} No doubt the courts were wary that probings into the defendant’s access would approximate too closely inquiry into actual use or intent, thereby further diminishing the prophylactic effect of the section already weakened by the potential for abuse test. The natural outgrowth of the search for potential abuse, however, was a realistic appraisal of an opportunity for access. Though Justice Douglas, dissenting, reiterated his position that the presumptions of access and abuse should be considered conclusive,\footnote{101} the majority opinion was clear: both had been rebutted by a ten percent owner in an unorthodox transaction.

The definition of the Kern transaction may prove decisive because the posture of the litigants was quite clear throughout the entire period under discussion. Moreover, the key elements which were found to have been present in the transaction—hostility, lack of control or realistic alternatives\footnote{102} and full disclosure\footnote{104} that could not possibly have lent itself to the speculative abuses § 16(b) was designed to prevent after it was stated that the insider did not, in fact, have access to inside information. Id. at 344-45. In Shaw v. Dreyfus, 172 F.2d 140 (2d Cir.), cert. denied, 337 U.S. 907 (1949), the court refused to hold that the receipt of a stock purchase warrant, awarded equally to all shareholders, was a purchase. It was stated that “[t]he transactions were based on knowledge of existing prices and hence devoid of any speculative element.” Falco v. Donner Foundation, Inc., 208 F.2d 600, 604 (2d Cir. 1953) (simultaneously matched purchase and sale). See also Silverman v. Landa, 306 F.2d 422, 425 (2d Cir. 1962) (straddle).

100. In American Standard, Inc. v. Crane Co., 346 F. Supp. 1153 (S.D.N.Y. 1971), although the court recognized that the presumption of access was rebuttable, it went on to find, on facts similar to those in Kern, that the presumption had not been rebutted. Id. at 1159.

101. 411 U.S. at 611 (Douglas, J., dissenting).

102. Despite the apparent inconsistency of the Court in Reliance and Kern, the two decisions have been harmonized. See the Supreme Court, 1972 Term, 87 Harv. L. Rev. 57, 295 n.29 (1973). See also 15 B.C. Ind. & Com. L. Rev. 149, 159-62 (1973). One curious point to note is that Justice Stewart, accredited with having precipitated the pragmatic approach to § 16(b) while sitting on the Sixth Circuit Court of Appeals, see note 26 supra, wrote the majority opinion in Reliance, while Justice Douglas advocated a subjective approach to § 16(b) in his dissent. Justice Stewart joined Justice Douglas’ dissent in Kern however.

103. Under California law there are no appraisal rights for dissenters in a sale of assets. 411 U.S. at 586 n.9. In addition, although Occidental registered its opinion that the merger would be beneficial, its abstention from voting at the shareholder meeting when the Kern-Tenneco merger was approved was equivalent to a vote against the merger. Id. at 599-600. It was pointed out by Justice Douglas though, that when the option was executed Occidental’s attorney was authorized to vote the Old Kern shares in favor of the merger and he
enabled the Court to apply its "possibility of abuse" test in a factual context with relative ease. In the conventional merger situation, on the other hand, the negotiations usually are more secretive, with both parties striving to reach a satisfactory agreement. In short, it may prove extremely difficult in the latter type of situation to draw as clear a line, particularly with regard to access, as the Kern Court was able to do in the defeated tender offer context. In addition, the Court clearly was not faced with an unorthodox transaction alleged to have constituted a purchase, nor were officers or directors involved.

Thus, one can readily observe the significance of the first major case in the wake of Kern—Gold v. Sloan—wherein the Fourth Circuit was confronted with a transaction incorporating all of the above elements. The district court in Gold found a potential for abuse in the Atlantic-Susquehanna merger scheme, primarily because two days prior to the public announcement of the merger, defendant Sloan received a letter from Susquehanna's chairman containing the estimated value of the preferred stock to be exchanged. Drawing a parallel to the Neawmark case, the court stated:

The defendants were aware on... (Monday) of the market value of preferred stock SC would issue in exchange for their ARC common. This was not made public until... (Wednesday). Thus the defendants had a 48-hour advantage over the general public for speculation. Clearly this presented the defendants with the opportunity for abuse, which Section 16(b) was designed to prevent.

Thus, the defendants were held to have purchased the Susquehanna securities when they were received in the subsequent exchange.

Although it is not clear, apparently the court was saying that the defendants could have purchased Atlantic securities during that two-day period, waited until the news of the merger was released, and then either sold the securities or exchanged them for the Susquehanna preferred and then sold. In either case, a potential for abuse was present. Despite this potential the court failed even to mention the essential basis for liability in such a context: the post-purchase access to inside information. The court merely cited Stella for the proposition that section 16(b) applies in these situations. As in Neawmark, the court could have been relieved of this duty only when it was apparent that the votes were not essential. Id. at 616 (Douglas, J., dissenting). When viewed in this light the distinguishing of the Bershad case, note 91 supra, was somewhat weaker.


105. Occidental had argued that there has been no case which imposed § 16(b) liability where the defendant did not control or have a realistic alternative to the alleged § 16(b) event. Thus, these factors certainly are probative on the issues of access and abuse and have played a large—if not decisive—role in the determination of whether there has been a sale. See Brief for Respondent at 58 and cases cited, Kern County Land Co. v. Occidental Corp., 411 U.S. 582 (1973).

106. 324 F. Supp. at 1214.

107. Id.

108. Id. at 1215.

109. Id.
have predicated liability on the presumptions attaching once insider status was acquired; but it was clear that the pre-insider period was the focal point of the opinion. Since the defendants were not then in a section 16(b) relationship to Susquehanna, it would appear that considerably more emphasis should have been placed on the potential for abuse after the exchange.

The remaining portion of the opinion was directed at establishing the actual status of the defendants. As to Sloan and Scurlock, both of whom occupied top level management positions in Atlantic in addition to their status as ten percent owners, there was no difficulty in finding that they were insiders under the Act. Defendant Rumbel, however, who was found to have been involved in "mere staff functions" involving "routine administrative chores," was not an insider. With regard to the remaining two defendants the court stated:

Although there was no evidence indicating that [they] had an opportunity to avail themselves of the inside details of the merger arrangement—Section 16(b) does not so require—They were corporate officers both in name and in fact.

Thus, all except Rumbel were held to the contents of the letter. In discussing the potential to abuse this access it was apparent that the court was employing the pre-Kern abuse test. The differentiation amongst the defendants, although ap-

110. Sloan was the chief executive officer of Atlantic and chairman of the board owning 16.52 percent of the common stock. Scurlock was a member of the board of directors and owned 19.68 percent of the common. Each became beneficial owners and directors of Susquehanna after the merger and Sloan became chief executive officer. Id. at 1213-15. Defendants McBride and Sloane were vice presidents of Atlantic before the merger and continued in similar capacities with Susquehanna. McBride had been the manager of a division of Atlantic while Sloane was the manager of a subsidiary. Id. at 1215 (McBride did not appeal the decision of the district court). From the district court opinion the position of defendant Rumbel was not clear, but the appellate opinion indicated that he was a senior vice president of Atlantic prior to the merger and a senior vice president of Susquehanna's subsidiary afterward. 486 F.2d at 358 (Winter, J., concurring & dissenting).

Technically, the defendants assumed their positions three days prior to the effective date of the merger. The lower court mentioned this fact with regard to Sloan and Scurlock, 324 F. Supp. at 1214-15, but it was ignored on appeal. Thus, the court of appeals apparently felt defendants did not enjoy statutory insider's positions in Susquehanna until after the merger. For an excellent discussion of the possibilities available to insiders in these premerger positions see Comment, Stock Exchanges, supra note 9 at 1049-59. Of course if the defendants had purchased Atlantic securities in the six-month period prior to the merger, § 16(b) liability might have been found for their sale in the exchange. See Schur v. Salzman, 365 F. Supp. 725 (S.D.N.Y. 1973).

111. 324 F. Supp. at 1215.

112. Id. The court of appeals was to refer to this reasoning as employing the objective approach inasmuch as there had been no evidence of access. 486 F.2d at 351. This was somewhat incorrect because, at the time of the lower court's decision, inquiries into access were not conducted by the court. The court of appeals was of the opinion that once the lower court found that there was no evidence of access, nonliability automatically should have followed. Id. Thus, it appears that the burden of proof is to be placed on the plaintiff to prove a possibility of access.
pearing to foreshadow the Kern inquiry into access, resembled more a judicial finding that Rumbel had not been an officer within the meaning of the Act than it did a determination that he did not have access to inside information. This conclusion is supported by the court's disposition of the last two defendants. Once they were held to be officers in fact the presumption took effect and they were held to the contents of the letter, even though there was no evidence indicating access. In the aftermath of Kern, these classifications were revised drastically by the court of appeals.

At the outset of the appellate opinion, the majority adopted the two-pronged pragmatic test announced in Kern. The issue to be decided in the unorthodox transaction was "whether the defendant 'had or was likely to have access to inside information ... so as to afford it [or him] an opportunity to reap speculative, short-swing profits' ...." Consistent with this new emphasis on access, the court conducted a more thorough inquiry into the "manifestly different" positions of the several defendants to determine whether the exchange should be considered a purchase of the securities. In structuring their analysis, however, the majority held that, since the issue was whether the transaction in question presented the opportunity for speculative abuse, there need be no inquiry into facts and circumstances occurring after the exchange, as these could not be relevant to a determination of the abuse of possibilities available to the defen-

113. This was implied in the court of appeals decision since the court there found that Rumbel had no access to inside information but recognized that the lower court had placed its holding on another ground. 486 F.2d at 351. See also id. at 358 (Winter, J., concurring & dissenting). The SEC defines "officer" to include "a president, vice-president, treasurer, secretary, comptroller, and any other person who performs for an issuer, whether incorporated or unincorporated, functions corresponding to those performed by the foregoing officers." Securities and Exchange Commission rule 3b-2, 17 C.F.R. § 240.3b-2 (1973).

114. This distinction was essential prior to Kern because the statutory insider was presumed conclusively to have access to inside information. But cf. Morale v. Arlen Realty & Dev. Corp., 352 F. Supp. 941, 944-45 (S.D.N.Y. 1973). Early in the history of this section however, it was recognized that merely because one had the title of an officer, the question of whether the individual was a § 16(b) officer was not foreclosed. Colby v. Klune, 178 F.2d 872 (2d Cir. 1949). In that case, the court in dictum determined that the term officer in the § 16(b) sense "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." Id. at 873. This approach was followed recently in Schimmel v. Goldman, 57 F.R.D. 481, 485-86 (S.D.N.Y. 1973). Nevertheless, there is authority upholding rule 3b-2. Lockheed Aircraft Corp. v. Rathman, 106 F. Supp. 810 (S.D. Cal. 1952). There, the term officer was held not to encompass one who assists an officer or performs any of the functions of the officer during his absence. Id. at 813. See also Lockheed Aircraft Corp. v. Campbell, 110 F. Supp. 282 (S.D. Cal. 1953). In addition, where the officer does not perform the duties of that office in the issuer but merely in a subsidiary of the issuer, the section is not applicable. Lee Nat'l Corp. v. Segur, 281 F. Supp. 851, 852 (E.D. Pa. 1968). See also Selas Corp. of America v. Vooogd, 365 F. Supp. 1268, 1270-71 (E.D. Pa. 1973).

115. 486 F.2d at 344 (quoting 411 U.S. at 596).
dants when the transaction took place.\textsuperscript{116} Thus, the investigation surrounding the unorthodox transaction should be limited “to the negotiations leading up to and including the finalization of the unorthodox transaction itself, which is the one transaction in question.”\textsuperscript{117} Accordingly, the merger date was the cutoff point for inquiry into opportunities for access and abuse.

The information contained in the letter which had played a large part in the lower court’s decision was discarded by the court of appeals because the letter addressed to Sloan had not been distributed to the remaining defendants prior to the actual date of the public announcement.\textsuperscript{118} Moreover, there had been a proxy statement issued ten days earlier which had given the estimated market value of the Susquehanna offer.\textsuperscript{119} Instead, the court focused on the negotiations and the activities incident to them as the potential sources for inside information. Here the inquiry was really directed at defendant Sloan because he had conducted all the negotiations in his capacity as Atlantic’s chief executive without the assistance of the others.\textsuperscript{120} Nor were the other defendants privy to the reports and results of his investigations which included “access to the books and records of Susquehanna during this period”\textsuperscript{121} and a personal examination of Sus-

\textsuperscript{116} Id. at 349.
\textsuperscript{117} Id. at 343.
\textsuperscript{118} Id. at 347.
\textsuperscript{119} The court, citing Newmark, remarked that this disclosure had placed all the shareholders on an equal footing and thus there could be no unfair use of this information. Id. at 349; cf. 84 Harv. L. Rev. 1012, 1018-19 (1971). See also note 104 supra and accompanying text.
\textsuperscript{120} It was primarily in the court’s investigation of Scurlock’s activities and position that the effects of the Kern access test were most obvious. Though the contexts of the transactions were distinguishable and the insider was a director, several salient factors were present. Indeed, the key factors in the Kern transaction also appeared in Gold. See notes 103-05 supra and accompanying text. Scurlock had been engaged in a bitter struggle with Sloan for control of Atlantic and had lost his position of control about two years prior to the merger. He was only able to maintain his position on the board through cumulative voting and was excluded from all inner workings of the management. 486 F.2d at 344-45. The court found that he was merely a “disaffected stockholder and powerless director, tolerated but not welcomed by the management.” Id. at 344. The court also found that the same situation confronted him at Susquehanna. Id. at 349. This was clearly dictum, however, since the court declined to inquire into the post-merger possibilities of access and abuse. It is worthy of note that the court found that Scurlock had no realistic alternative but to exchange his shares despite the fact that he evidently cast the deciding vote for the merger. Although the plaintiff maintained that he could have opposed the merger, voted against it and demanded appraisal rights, the court stated that “the practical disadvantages of such a dissent by Scurlock appear so obvious as to have made unrealistic any assumption that he might have done so.” Id. at 350. See Morales v. Arlen Realty & Dev. Corp., 332 F. Supp. 941, 945 (S.D.N.Y. 1973), and cases cited therein. But see Blau v. Hodgkinson, 100 F. Supp. 361 (S.D.N.Y. 1951). It was also mentioned that Scurlock had bound himself in a previous proxy statement to vote in favor of the merger. 486 F.2d at 350. Thus hostility, lack of control or realistic alternatives, and full disclosure were again the key points to the decision. In a brief passage the court also found that defendants Rumbel and Sloane did not have “possible opportunit[ies] for abuse of inside information.” Id. at 351.
In addition, Atlantic's financial advisor had been selected personally by Sloan and reported only to him. There was nothing to indicate that this information was distributed to the other defendants and it was not until some time later that it was distributed to the Atlantic shareholders. During the crucial period before the merger this information amounted to superior knowledge about the financial condition and prospects of Susquehanna, and, although Sloan may not have used this information, the court believed the opportunity for abuse was present. Thus his receipt of the securities in the exchange constituted a section 16(b) purchase.

In a well-reasoned dissent, Judge Winter seriously questioned the limitation the majority placed on the court's investigation. Since the section was designed to prevent "injury to outsider shareholders of the issuer, caused by persons trading in the securities of the issuer who make use of information concerning the issuer, obtained by virtue of their status as insiders with respect to the issuer," he persuasively concluded that the period after the merger presented the crucial period during which the defendants were insiders of Susquehanna and could have disposed of their stock on the basis of inside information. Thus the defendants pre-merger opportunities for access and abuse should be of no concern to the court in a suit by a Susquehanna shareholder because during that period they occupied no relationship to the issuer through which access or abuse could be presumed. To so restrict the court's aperture, he concluded, would proscribe activities the section was not intended to reach and leave unattended an evil dearly within the purview of the statute. He further noted that the majority's reliance on the Kern decision for their proposition was misplaced, because there the limitation had been proper since the merger represented a closing disposition in the plaintiff-issuer's stock. In the instant case, however, the defendants could not have become insiders in the issuer until after the merger, and the inquiry should have been structured accordingly.

121. 486 F.2d at 351-52.
122. Id. at 352.
123. Id.
124. Id. It was due to this finding that Sloan had not willfully violated § 16(b) that the court denied the awarding of interest. Id. at 353.
125. Id. at 353-60.
126. Id. at 355.
127. Id. at 354.
128. Id. at 355. The SEC argued, as in Reliance, see note 75 supra, that there were three types of abuse present in such situations and that the merger should be termed a purchase. Brief for SEC at Amicus Curiae at 23-25, Gold v. Sloan, 486 F.2d 340 (4th Cir. 1973). The SEC also stressed, however, that the defendants occupied a unique position since they could time their sales on the basis of inside information, id. at 24-25, thus, to some extent, taking a position consistent with Judge Winter's dissent.
129. 486 F.2d at 354 (Winter, J., concurring & dissenting). At least one other circuit apparently has read the Kern decision as permitting an inquiry into post-merger opportunities. Champion Home Builders Co. v. Jeffress, 490 F.2d 611, 618-19 (6th Cir. 1974), petition for cert. filed sub nom. Jeffress v. Kramer, 42 U.S.L.W. 3585 (U.S. Apr. 4, 1974) (No. 73-1479). There, Champion acquired the corporation of which Jeffress was the sole owner.
While the district court had been careful to bring the transaction within the section through its recognition of the Stella interpretation, it was apparent that the basis of liability, as in Newmark and Marquette, rested on potential for abuse arguably outside the scope of section 16(b). The majority opinion took the final step and dispensed with any necessity for reliance on the post-purchase period. Yet as previous cases clearly recognized, this period is essential to any application of section 16(b) to such situations. Inasmuch as the pragmatic approach was originated to further congressional intent, the complete abandonment of consideration of the only time period during which the insider can be presumed to have access to inside information can only raise grave doubts about the approach. Should Congress amend the section to encompass such activity there would be no difficulty; as the section now stands, however, the construction espoused by the Fourth Circuit is inconsistent not only with the limited purpose behind the section but also with those decisions which have recognized that section 16(b) liability must rest on statutory possibilities for access. In Gold there should have been no doubt that Sloan could have been held to his opportunity for access and abuse after the merger had taken place. Moreover, as the dissent indicated, Scurlock may well have had identical opportunities. If it were determined that there was no access or abuse after the merger, and it may well be questioned as to the necessity of such a determination since only a cash sale would be involved, the litigant would be forced to seek relief under rule 10b-5 or a state derivative action. While these remedies require proof of fraud or misuse, they are not subject to the many limitations imposed by section 16(b) and do allow the plaintiff considerable latitude in proving his claim.

Peter M. Dugré

After the exchange Jeffress became an officer and director of Champion. The key area of abuse lay in the period after the merger when Champion announced a stock split and Jeffress sold a portion of the stock he had received in the exchange. Since he played an active role in the management of Champion and had access to all financial records of the company, he was held liable under § 16(b). Id.

However, the court distinguished Newmark, noting that Jeffress had no advance knowledge of the merger. Id. at 617. Thus, the court did not express an opinion on pre-merger inquiries. Likewise, in Allis-Chalmers Mfg. Co. v. Gulf & W. Indus., Inc., [Current Binder] CCH Fed. Sec. L. Rep. ¶ 94,421 (N.D. Ill., Jan. 30, 1974) (discussed at note 49 supra), the court relied on Stella and the post-purchase possibility of abuse to hold the initial transaction a § 16(b) purchase. Id. at 95,433-35.

130. 486 F.2d at 359 (Winter, J., concurring & dissenting).
131. Id. at 357; cf. notes 11 & 110 supra. As to Sloane, Judge Winter again would have looked to the post-merger period to discover if opportunities for abuse were present and remanded for a determination of whether, as an officer of a subsidiary, he performed similar functions for the parent. 486 F.2d at 359. See notes 113 & 114 supra.

135. See Schein v. Chasen, 478 F.2d 817 (2d Cir. 1973), vacated & remanded sub nom.