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PRAGMATIC DISGORGING OF INSIDER PROFITS: A REVIEW OF CASES REPORTED UNDER SECTION 16(b)

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The dismal lack of public participation in the market today reflects the flight of the small investor, whose commitments in stocks have resulted in too many losses. Recently Paul Kolton, President of the American Stock Exchange, testified that there were about 800,000 fewer individual investors in listed securities in 1972 than in the previous year. One reason for this sharp drop in trading by the small investor, Kolton said, was that the individual stockbroker had simply become convinced that he did not trade in the market on equal terms with large or institutional investors.[1] Any instrument to help bring the public back into the market must therefore be seen to have a renewed importance when securities exchanges no longer function in their quest to raise equity capital for corporate expansion.

One of the strongest instruments available is Section 16(b) of the Securities Exchange Act of 1934.[2] The introductory clause of section 16(b) shows that it was enacted "[f]or the purpose of preventing the unfair use of information which *may* have been obtained"[3] by a corporate insider. But the statute by its terms does not require a showing of the actual use of the information, fair or unfair, in order for profits to be recoverable. As conceived by Congress, the statute was a hatchet, not a scapel—a flat, blunt rule taking the profits out of a class of transactions in which the possibility of abuse was considered unusually high. Thus it

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1. Deposition testimony of Paul Kolton, in Shumate & Co. v. American Stock Exch., Civil No. 3-4708-D (N.D. Tex., filed Apr. 22, 1971).
2. 15 U.S.C. § 78p(b) (1970).
3. *Id.* (emphasis added).

was aimed at protecting the public by preventing insiders from profiting in securities on the basis of information not available to the general market.[4]

In addition to section 16(b), other instruments of investor incentive include the creation of a central market place, with full disclosure of all transactions in all securities, and the elimination of all artificial barriers to trading, such as Rule 394 of the New York Stock Exchange, which requires that listed securities be traded only on the floor of the exchange absent exceptional circumstances. These are beyond the scope of this article. But in this broader spectrum, where the large demands of the electronic stock market of the future must be met, section 16(b) has limited utility because transactions legally may be structured to circumvent it. Yet it is still part of the arsenal at hand and should therefore be examined.

The First 15 Years of Section 16(b)

In 1949 this writer published a study entitled, *Automatic Disgorging of Insider's Profits Under Section 16(b) of the Securities Exchange Act of 1934.*[5] A review of the many cases since publication of that paper suggests that a more appropriate title today would be, "A Less-than-Automatic, Pragmatic, Subjective Disgorging of Insider's Profits under Section 16(b)." In 1949, 15 years after passage of the Act, there were only 13 reported cases under section 16(b). The first and most important of those cases was *Smolowe v. Delendo Corp.*[6] This case disposed of the contention that to compel a defendant to disgorge his profits without proof that he took unfair advantage of his position would be to deprive him of his property without due process of law. It was argued that a proper construction of the statute would not strike down good-faith transactions within six months and at the same time leave untouched bad-faith transactions extending over a longer period. The court, in answering this objection, pointed out that the framers of the Act considered an *objective* or *automatic* standard of proof necessary for an effective remedy, since the burden of proving an intent at the time of purchase to sell within six months would ordinarily be too difficult. "Bona fide transactions, too," the court said, "may be caught in the net of the law. But what it legitimately struck at is the tendency to evil in other cases."[7]

4. S. REP. No. 792, 73d Cong., 2d Sess. 9 (1934).
5. 27 TEXAS L. REV. 840 (1949).
6. 136 F.2d 231 (2d Cir.), *cert. denied*, 320 U.S. 751 (1943).
7. *Id.* at 240.

LANDMARK: BLAU V. LEHMAN

At the time of the 1949 study there were no Supreme Court cases for review, and in fact nearly 28 years were required for the first case under the Act to make it all the way to the highest tribunal. *Blau v. Lehman*,[8] in the dissenting words of Mr. Justice Douglas, substantially eliminated "the great Wall Street trading firms" from the prohibitions of section 16(b). Such result followed, in the view of the dissent, because so many partners of investment banking firms served as directors of major corporations, and indeed Lehman Brothers, defendant in the case, was shown to have partners on 100 boards of large companies. Under the holding of the majority, Douglas felt, Lehman Brothers could make "a rich harvest" on inside information because each partner need disgorge only his distributive share of his firm's profits on confidential information, with the other partners keeping the balance. "This," he wrote, "is a mutilation of the Act."[9]

For the dissent the solution was to make the partnership a "director" for purposes of section 16(b).[10] Indeed, under other provisions of the Act, reference is made to a person who is a director, and the word person is defined to include a partnership. The majority opinion held that the definitions in the Act merely meant that a partnership *could* be treated as an entity under the statute, not that it would be, and that no reason at all was afforded for construing the word "director" in section 16(b) as though it read "partnership of which the director is a member." The majority therefore refused to render judgment against the Lehman partnership, or the one Lehman partner who was a director of the corporation upon whose behalf recovery was sought, for the $98,-686.77 profits the partnership was found to have realized from its short-swing stock transactions. Recovery was only allowed against the partner individually for $3,893.41, representing his distributive share of the partnership gain.

The majority is not altogether persuasive in arguing that the broadening of the categories of persons on whom the liabilities of section 16(b) are imposed was considered and rejected by Congress when it passed the

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8. 368 U.S. 403 (1962).
9. *Id.* at 415.
10. *Id.* at 415-16. In the recent case of Simon v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 482 F.2d 880 (5th Cir. 1973) the court refused to treat a brokerage house as an insider, even though it owned 27.4% of the outstanding common stock of Scientific Controls Corp. The brokerage house held the stock in the street name for the benefit of its customers, rather than in an investment account.

Act. It is true that drafts of provisions that eventually became section 16(b) would have made all profits received by anyone, whether an insider or not, recoverable by the company, providing unlawful disclosures had been made. But the proper question before the Court in *Blau v. Lehman* was simply whether a partnership could be a "director" within the meaning of the statute. Therefore, there is some merit to the dissent, which complained that:

> We forget much history when we give Section 16 a strict and narrow construction. . . .
>
> What we do today allows all but one partner to share in the feast which the one places on the partnership table. They in turn can offer feasts to him in the 99 other companies of which they are directors. . . . This result is a dilution of the fiduciary principle that Congress wrote into Section 16 of the Act. It is, with all respect, a dilution that is possible only by a strained reading of the law. Until now, the courts have given this fiduciary principle a cordial reception. We should not leave to Congress the task of restoring the edifice that it erected and that we tear down.[11]

Two other cases have reached the Supreme Court, both closely decided and controversial. Three Justices dissented in each, and each time Mr. Justice Douglas wrote a dissenting opinion arguing for applicability of the statute to require the disgorging of profits.

RELIANCE ELECTRIC AND THE TWO STAGE SALE

In *Reliance Electric Co. v. Emerson Electric Co.*,[12] the majority held that an investor can structure his transactions in a stock with intent of avoiding liability and thus escape the reaches of section 16(b). Emerson Electric Co. acquired 13.2 percent of the outstanding common stock of Dodge Manufacturing Co., pursuant to a tender offer made in an unsuccessful attempt to take over Dodge. This stock was bought at a price of $63 per share. Shortly thereafter the shareholders of Dodge approved a merger with Reliance Electric. Emerson, having been blocked in its attempt to take over Dodge, then followed a plan recommended by its general counsel to dispose of its shares with as little liability as possible. It therefore sold 37,000 shares of Dodge to a brokerage house at $68 per share, reducing its holdings in Dodge to 9.96 percent of the outstanding common stock. Two weeks later Emerson then sold its remaining shares directly to Dodge at $69 per share.

11. Blau v. Lehman, 368 U.S. 403, 419-20 (1962) (dissenting opinion).
12. 404 U.S. 418 (1972).

Reliance made demand on Emerson for profits realized from both sales, and Emerson then filed a declaratory judgment action to adjudicate its liability under section 16(b). The Supreme Court held that there was liability under the first sale, when Emerson was an insider being more than a 10 percent shareholder, but no liability under the second sale when Emerson had reduced its holdings below the 10 percent requirement.[13] In reaching its decision, the Supreme Court said that it was following the mandate of Congress in applying a flat or mechanical rule capable of easy administration. It rejected a construction of the statute which would treat two sales as one upon proof of a pre-existing attempt by the seller that it had but a single plan of liquidation and merely split its sales in order to avoid most of the potential liability under section 16(b).

Mr. Justice Douglas began his dissent by noting that Emerson had made a profit exceeding $900,000, and that the majority was permitting Emerson not to account, under the statute, for the greater part of its gains. In his view, the "result is a mutilation of the Act, contrary to its broad remedial purpose, inconsistent with the flexibility required in the interpretation of securities legislation, and not required by the language of the statute itself."[14] The dissent argued that in the guise of an objective approach the majority was undermining the statute:

> By the simple expedient of dividing what would ordinarily be a single transaction into two parts—both of which could be performed on the same day, so far as it appears from the Court's opinion—a more-than-10% owner may reap windfall profits.[15]

Such a result was clearly against congressional intent and the Court "should hold that there was only one sale—a plan of distribution conceived 'at the time' Emerson owned 13.2 percent of the Dodge stock, and implemented within six months of a matching purchase."[16] Moreover, the dissenters would presume any split sale by a 10 percent owner to be part of a disposition plan.

It was pointed out in the dissent that a tender offer, although it may be described as a series of discrete purchases, has been treated as a single purchase, citing *Abrams v. Occidental Petroleum Corp.*,[17] and in the early cases under section 16(b) use of a mechanical or arbitrary

13. *Id.* at 426.
14. *Id.* at 428.
15. *Id.* at 431.
16. *Id.* at 432.
17. 323 F. Supp. 570 (S.D.N.Y. 1970), *rev'd*, 450 F.2d 157 (2d Cir. 1971).

standard in determining its applicability ordinarily resulted in liability against the insider. Here, however, an opposite effect was achieved.

The dissent further criticized the majority for its reasoning that to treat "two sales as one upon proof of a pre-existing intent by the seller" eroded the "mechanical quality" of the statute.[18] Indeed, Douglas wrote, the "mechanical quality" was illusory, in that there is no rule so objective or automatic that it does not require some mental effort in applying it. The better rule, in order not to defeat the avowed objective of section 16(b), would be for federal courts to resolve "all doubts and ambiguities against insiders."[19] Unquestionably, the majority opinion will serve to weaken the preventive purposes of 16(b), a result which could logically have been avoided in Douglas' words by merely construing the statute as allowing a rebuttable presumption that any such series of dispositive transactions be deemed part of but a single plan of disposition, to be treated as a single "sale" for the purposes of section 16(b).

PRAGMATIC DISGORGING: KERN COUNTY LAND CO.

The following year the Supreme Court seemed to abandon the mechanical or objective approach it had just adopted in *Reliance Electric* by determining that an exchange was not a sale and that a profit of more than $19 million on shares obtained through a tender offer was therefore not recoverable under section 16(b). In *Kern County Land Co. v. Occidental Petroleum Corp.*,[20] the latest 16(b) case to reach the Court, a take-over attempt by Occidental of Kern County was blocked when Kern was able to negotiate a defensive merger with Tenneco, Inc. Fearing that the Kern stock it had acquired by tender offer would then cause it to be locked in a minority position in Tenneco, Occidental negotiated an arrangement whereby Tenneco was granted an option to purchase all of the Tenneco preference stock to which Occidental was entitled in exchange for its Kern stock, when and if the Kern-Tenneco merger was closed. The question before the Court was whether a "sale" within section 16(b) took place either when Occidental became irrevocably bound to exchange its shares of Kern for shares of Tenneco, or when Occidental gave an option to purchase the Tenneco shares so acquired. The majority concluded that a sale had not occurred for the reason that it was,

18. Reliance Elec. Co. v. Emerson Elec. Co., 404 U.S. 418, 435 (1972).
19. *Id.* at 436, *citing* Blau v. Oppenheim, 250 F. Supp. 881, 884-85 (S.D.N.Y. 1966).
20. 411 U.S. 582 (1973).

> totally unrealistic to assume or infer from the facts before us that Occidental either had or was likely to have access to inside information, by reason of its ownership of more than 10% of the outstanding shares of Old Kern, so as to afford it an opportunity to reap speculative, short-swing profits.[21]

This statement of the highest Court is a far cry from the approach followed in *Smolowe v. Delendo*,[22] and indeed from the language of the same Court just one year earlier in *Reliance Electric*. In a footnote to the majority opinion, recognition was given to "several decisions" applying a so-called objective test in interpreting and applying section 16(b),[23] among them the *Smolowe* decision. Under the objective or mechanical approach, section 16(b) is held to be applicable whether or not the transaction in question could possibly lend itself to the types of speculative abuse that the statute was designed to prevent. The Court stated, however, that the greater weight of authority holds that a pragmatic approach to section 16(b) will best accomplish the legislative purpose.

In his dissent Douglas wrote that the majority, "in resorting to an *ad hoc* analysis of the 'possibility for the speculative abuse of inside information,' " was charting a course for the interpretation of section 16(b) that "undermines the congressional purpose."[24] By its own terms the statute was applicable, irrespective of any actual or potential *use* of inside information to gain a trading advantage. The dissenters concluded that it was inescapable that Occidental purchased and sold shares of Kern within a six-month period and that this "round-trip" in Kern stock should be covered by the literal terms of section 16(b).

The Supreme Court in *Reliance Electric* had stated that, "the only method Congress deemed effective to curb the evils of insider trading was a *flat rule* taking the profits out of a class of transactions in which the possibility of abuse was believed to be intolerably great."[25] The dissent in *Occidental* reasoned that it was one thing to interpret the terms "purchase" or "sale" liberally in order to include transactions within the ambit of the statute, but quite another to abandon the mechanical test of the statute in order to relieve litigants of liability.[26]

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21. *Id.* at 596.
22. 136 F.2d 231 (2d Cir.), *cert. denied*, 320 U.S. 751 (1943).
23. Kern County Land Co. v. Occidental Pet. Co., 411 U.S. 582, 594 n.26 (1973).
24. *Id.* at 605.
25. Reliance Elec. Co. v. Emerson Elec. Co., 404 U.S. 418, 422 (1972) (emphasis added).
26. Kern County Land Co. v. Occidental Pet. Co., 411 U.S. 582, 613 (1973).

There is no doubt that the majority has left the approach of the Court to section 16(b) cases less than clear by its waffling in two significant cases decided within just one year of each other, and it is no surprise that the dissent would complain in the *Occidental* litigation that it was this "objective standard that the Court hung to so tenaciously in *Reliance Electric*, but now apparently would abandon to a large extent."[27] Probably the best analysis of the three Supreme Court cases involving section 16(b) is that Douglas and other dissenters will resolve all doubts and ambiguities against insiders in order to hold section 16(b) applicable, while the majority, claiming now to follow the pragmatic test, will actually determine each case on its own facts to achieve the desired result.

FORTY-ONE YEARS OF SECTION 16(b)

Since its enactment more than 40 years ago, there have been about 200 reported cases under section 16(b). The number of cases is probably no measure of the effectiveness of the law, however, its very existence serves, at least to some extent, as a deterrent to abuse of confidential information in stock transactions. Most corporate officers and directors, and legal counsel advising them, know of the statute and seek to avoid liability under it. The first 13 cases under the statute were reviewed in the writer's 1949 survey. The next 153 or so reported cases in the 21 year period until 1970 qualify, as aptly put by Louis Loss, as having a "generalization-defying nature."[28] Brief mention may, however, be made of a few of the more important cases decided during this period.

In the majority's footnote in the *Occidental* case, citation was made to *Smolowe v. Delendo*,[29] *Park & Tilford v. Schulte*,[30] and *Heli-Coil Corp. v. Webster*[31] as cases in which the so-called "objective" test was applied in interpreting section 16(b). In the *Heli-Coil* case, a corporation brought suit against one of its directors to recover short-swing profits. It was held that conversion of debentures into common stock at a time when each debenture was the substantial equivalent of stock did not constitute a realization of profit, but that sale of stock after conversion was subject to the statute. While observing that the Act renders unprofit-

27. *Id.* at 613.
28. 5 L. Loss, SECURITIES REGULATION 3029 (Supp. 1969).
29. 136 F.2d 231 (2d Cir.), *cert. denied*, 320 U.S. 751 (1943).
30. 160 F.2d 984 (2d Cir.), *cert. denied*, 332 U.S. 761 (1947).
31. 352 F.2d 156 (3d Cir. 1965).

able short-swing speculations by insiders, the Third Circuit noted:

> [T]rial courts and courts of appeals have taken two divergent roads to what they deem to be the same end. One road leads out of *Park & Tilford*; the other from *Ferraiolo v. Newman*. The test of the first is very largely objective; the second, in part, at least, seems subjective.[32]

Ferraiolo rests on the notion that "[e]very transaction which can reasonably be defined as a purchase will be so defined, *if the transaction is of a kind which can possibly lend itself to the speculation encompassed by Section 16(b)*."[33] Since determination whether a transaction can lend itself to speculation must be made by review of at least some facts, the approach in *Ferraiolo* is deemed to be subjective or pragmatic. Curiously, the author of *Ferraiolo* was Mr. Justice Stewart, the same jurist who later wrote the majority opinion for the Supreme Court in *Reliance Electric*, in which the Court was deemed to have returned to the objective standard in the controversial "split-sale" case.

In *Pettys v. Butler*,[34] involving the question whether a conversion of convertible preferred stock to common stock constituted a purchase within the statute, the court held that an incorrect interpretation had probably been placed on *Park & Tilford* and *Heli-Coil*, both of which had been interpreted as requiring blunt application of section 16(b) to all stock conversions without regard to the purposes of the Act. The court stated that:

> Since *Park & Tilford*, the Second Circuit has examined each case on *ad hoc* basis to determine whether the transaction came within the purpose of the Act. It specifically refused to be bound by a 'black leather rubric' or a 'rule of thumb' as *Park & Tilford* supposedly demanded.[35]

Blau v. Lamb[36] again recognized the two differences in approach in determining applicability of section 16(b) to the question of whether a conversion constituted a "purchase" or "sale." The court favored the approach that required a determination of whether the transaction in question could tend to accomplish what the Act was designed to prevent, that is, the unfair use of inside information for a short term profit.

32. *Id.* at 164; *see* Ferraiolo v. Newman, 259 F.2d 342 (6th Cir. 1958), *cert. denied,* 359 U.S. 927 (1959); Park & Tilford v. Schulte, 160 F.2d 984 (2d Cir.), *cert. denied,* 332 U.S. 761 (1947).

33. Ferraiolo v. Newman, 259 F.2d 342 (6th Cir. 1958), *cert. denied,* 359 U.S. 927 (1959) (emphasis added).

34. 367 F.2d 528 (8th Cir. 1966).

35. *Id.* at 533.

36. 212 F.2d 82 (2d Cir. 1954).

Similarly, in *Roberts v. Eaton*,[37] it was observed that in a "growing number of 16(b) precedents as to what constitutes a sale or purchase, two lines of cases are gradually emerging, though the dividing line is as yet somewhat shadowy."[38] One line was that leading from *Park & Tilford*; the other came from *Blau v. Mission Corp.*[39] and *Shaw v. Dreyfus.*[40] Also, in *Blau v. Max Factor & Co.*,[41] attention was given to the practices that section 16(b) was designed to prevent, in reaching the result that the statute in that case was not applicable, despite the arbitrary rule in conversion or exchange cases set by the *Park & Tilford* line of cases.

DEPUTIZATION THEORY

In another interesting area of the law under the Act, the Second Circuit in *Feder v. Martin Marietta Corp.*[42] observed that the judicial tendency had been to interpret section 16(b) in ways that were most consistent with the legislative purpose, "even departing where necessary from the *literal* statutory language."[43] But even this policy of interpretation did not permit an expansion of the statute to persons other than directors, officers and 10 percent shareholders, particularly in light of *Blau v. Lehman*,[44] where the Supreme Court had refused to hold a partnership to be a director within the meaning of the statute. However, by the creation of a legal fiction called the deputization theory, the courts have managed to remain within the limits of section 16(b)'s literal language while expanding the reach of the Act. This fiction was given its impetus in *Rattner v. Lehman*,[45] where Judge Learned Hand, in a concurring opinion discussing the question whether a partnership is subject to section 16(b) liability whenever a partner is a director of a corporation whose stock the partnership traded, stated:

> I agree that § 16(b) does not go so far; but I wish to say nothing as to whether, if a firm deputed a partner to represent its interest as a director on the board, the other partners would not be liable. True, they would not even then be formally 'directors;' but I am

37. 212 F.2d 82 (2d Cir. 1954).
38. *Id.* at 83.
39. 212 F.2d 77 (2d Cir. 1954).
40. 172 F.2d 140 (2d Cir. 1949).
41. 342 F.2d 304 (9th Cir. 1965).
42. 406 F.2d 260 (2d Cir. 1969).
43. *Id.* at 262 (emphasis added).
44. 368 U.S. 403 (1962).
45. 193 F.2d 564 (2d Cir. 1952).

not prepared to say that they could not be so considered; for some purposes the common law does treat a firm as a jural person.[46]

The Supreme Court in *Lehman* was of the view that the issue of deputization was a question of fact to be settled case by case rather than a conclusion of law, but implicit in the decision was the availability of the deputization theory to impose section 16(b) liability.[47]

Lower Court Cases During the Period 1949-1969

Among the large mass of cases decided from 1949 through 1969 several other cases are worthy of note. Distinguishing between officers and directors and 10 percent owners, the courts have determined the difficult question of the time at which insider status attaches. As to the former, the statute requires the office to be held at the time of both purchase and sale.[48] But liability for sales, while one is a director, has been found even though the purchases occurred prior to the defendant's assuming a directorship.[49] In the same vein, liability has attached for sales after termination of directorship status where the purchases occurred while defendant was serving as a director.[50] In *Lee National Corp. v. Segur*[51] it was held that an officer in a subsidiary of a corporation was not liable for short-swing profits in transactions in the stock of the parent company. The circumstances indicated that the defendant's officership in the subsidiary rather than the parent was not a subterfuge for avoiding section 16(b). In *Perfect Photo, Inc. v. Sentiff*,[52] the purchase and sale of stock was held to be a short-swing transaction resulting in liability to an insider under section 16(b) even though the stock in question was not registered under a national securities exchange until after purchase of the stock by the defendant. In *Chemical Fund, Inc. v. Xerox Corp.*,[53] the court rejected the contention that ownership of more than 10 percent of an outstanding class of convertible debentures constituted the owner a beneficial owner of 10 percent of a class of equity security. The test applied was the percentage of the underlying class of equity security which would be owned, assuming conver-

46. *Id.* at 567.
47. This was recognized in Marquette Cement Mfg. Co. v. Andreas, 239 F. Supp. 962 (S.D.N.Y. 1965).
48. 15 U.S.C. § 78p (1970).
49. Adler v. Klawans, 267 F.2d 840 (2d Cir. 1959) (no liability under particular facts); Blau v. Allen, 163 F. Supp. 702 (S.D.N.Y. 1958).
50. Feder v. Martin Marietta Corp., 406 F.2d 260, 266 (2d Cir. 1969).
51. 281 F. Supp. 851 (E.D. Pa. 1968).
52. 205 F. Supp. 574 (E.D. Pa. 1962).
53. 377 F.2d 107 (2d Cir. 1967).

sion, and in this case only 2.7 percent of the corporation's common stock would have been owned if the debentures had been converted.[54]

SECTION 16(b) CASES SINCE 1970

Of the 30-odd section 16(b) cases to be reported since 1970, *Newmark v. RKO General, Inc.*[55] and *Bershad v. McDonough*[56] are two of the most interesting. *Newmark* first considered the threshold issue of whether the purchase and subsequent exchange of Central Airline shares by RKO, which at that time controlled Frontier Airlines, was the type of transaction which section 16(b) was designed to prevent. The court found "that RKO's heart may have been pure and its motivation noble matters not."[57] RKO's contract to purchase Central shares was the "classic example" of trading while in the possession of information unavailable to the general public. The prime question before the court was whether the subsequent exchange of Central shares for Frontier shares pursuant to a merger agreement constituted a "sale" of Central securities for the purposes of the statute. In finding liability, the circuit court disposed of the "economic equivalence" exemption established in *Blau v. Lamb.*[58]

The Second Circuit stated that section 16(b) was commonly termed "a crude rule of thumb,"[59] a description first employed by Thomas Corcoran, spokesman for the drafters of the statute, during congressional hearings on the bill which ultimately became section 16(b).[60] The phrase now serves to describe not only the statute but also one approach to its application, the so-called "objective" or "rule of thumb" approach, wherein the statute is applied to all transactions which seem to fall within its terms, without regard to whether imposition of liability would further the purposes of the statute. This approach was rejected by the Second Circuit in favor of the more "pragmatic" approach—applying the statute only to those situations subject to speculative manipulation.

54. *Id.* at 110. The Securities Exchange Commission has announced that it does not agree with the result reached in *Chemical Fund,* and will not follow it as regards the reporting requirements of § 16(a). SEC Exchange Act Release No. 8202 (Dec. 6, 1967); 17 C.F.R. § 240.16a-2 (1975).
55. 425 F.2d 348 (2d Cir. 1970).
56. 428 F.2d 693 (7th Cir. 1970).
57. Newmark v. RKO Gen., Inc., 425 F.2d 348, 353 (2d Cir. 1970).
58. 363 F.2d 507, 523 (2d Cir. 1966).
59. Newmark v. RKO Gen., Inc., 425 F.2d 348, 350 (2d Cir. 1970).
60. *Hearings Before the Senate Comm. on Banking & Currency,* 73d Cong., 2d Sess. 6557 (1934).

In *Bershad v. McDonough*,[61] liability against the defendant insider Bernard McDonough and wife was found in the amount of $612,000. No doubt the defendants were mindful of section 16(b) and thought they had structured their transactions safely beyond its grasp. They had purchased 282,726 shares of Cudahy Company common on March 15th and 16th, 1967. On July 20th the defendants and Smelting Refining & Mining Co. entered into an option agreement granting Smelting the right to purchase most of the Cudahy stock owned by defendants. Exercise of this option did not occur until September 27, 1967, slightly more than six months from time of stock purchase. But it was held under the circumstances of the case that the "sale" of the Cudahy stock should be dated as of the time of purchase of the option rather than its exercise. Particular circumstances clearly indicated that the stock was effectively transferred for practical purposes long before exercise of the option, in that a $350,000 binder was paid for the option, an irrevocable proxy was delivered to Smelting to vote the Cudahy shares, and the defendant resigned as chairman of the board and was replaced by the top officer of Smelting. In the text of its opinion the Seventh Circuit reviewed many of the cases discussed herein and contrasted the approaches followed in interpreting the statute, and then in a footnote stated:

> We do not feel obliged to enter the debate over the 'objective' versus 'pragmatic' approach which has consumed courts faced with transactions that are apparently 'sales' but without risk of speculative abuses and insider profiteering. The 'pragmatic' approach has never been extended to immunize transactions in which potential abuses of inside information can be seen. On the other hand, the 'objective' or 'rule of thumb' approach need not compel a court to wink at the substantial effects of a transaction which is rife with potential sharp practices in order to preserve the easy application of the short swing provisions under Section 16(b).[62]

The date of sale has been held to be the date of actual transfer rather than the slightly earlier date of an underwriting agreement.[63] The difference was not enough to save the defendant from section 16(b) liability, but was used as the date for the purpose of computing recoverable profits. On the other hand, a district court held that the purchase date was the date of a handshake agreement approved by the board of directors of the seller rather than the date when the agreement was

61. 428 F.2d 693 (7th Cir. 1970).
62. *Id.* at 697 n.5.
63. Brenner v. Career Academy, Inc., 467 F.2d 1080 (7th Cir. 1972).

reduced to writing.[64] The court reasoned that the judiciary had shifted from a rigid, objective interpretation of section 16(b) to a more subjective or pragmatic approach.[65] Unfortunately, the appellate court did not agree.[66]

Two other recent cases have reached the question of what constitutes a purchase or sale under section 16(b). The Fifth Circuit held that the exercise of an employee stock option was a purchase, the objective standards of section 16(b) requiring this result.[67] Another court also applied a strict standard when it deemed stock pledged as security for a bank loan to have been "sold" by the insider-borrower.[68]

Insider Restrictions Under Rule 10b-5

No discussion of stock transactions by insiders can be complete without assessing the impact of rule 10b-5;[69] its trading consequences were sharply adjudicated by the Second Circuit in *Securities & Exchange Commission v. Texas Gulf Sulphur Co.*[70] This rule is based in policy on the justifiable expectation of the securities market place that all investors trading on impersonal exchanges shall have relatively equal access to material information.[71] The Second Circuit found the rule applicable to those "possessing the information who may not be strictly termed an 'insider' *within the meaning of Sec. 16(b) of the Act*."[72]

The court went on to say that anyone in possession of material inside information must either disclose it to the investing public, or if disabled from disclosing it in order to protect a corporate confidence, he must abstain from trading in or recommending the securities concerned while the inside information remains undisclosed. Yet an insider is not always foreclosed from investing in his own company merely because he may be more familiar with company operations than are outside investors.

64. Champion Home Builders Co. v. Jeffress, 352 F. Supp. 1081 (E.D. Mich. 1973), *rev'd*, 490 F.2d 611 (6th Cir. 1974).
65. *Id.* at 1082.
66. Champion Home Builders Co. v. Jeffress, 490 F.2d 611 (6th Cir. 1974).
67. *See* Keller Indus., Inc. v. Walden, 462 F.2d 388, 390 (5th Cir. 1972).
68. Alloys Unlimited, Inc. v. Gilbert, 319 F. Supp. 617 (S.D.N.Y. 1970).
69. 17 C.F.R. § 240.10b-5 (1975).
70. 401 F.2d 833 (2d Cir. 1968).
71. In that case it was stated that:

> The essence of the Rule is that anyone who, trading for his own account in the securities of a corporation has 'access, directly or indirectly, to information intended to be available only for a corporate purpose and not for the personal benefit of anyone' may not take 'advantage of such information knowing it is unavailable to those with whom he is dealing,' i.e., the investing public.

Id. at 848.

72. *Id.* at 848 (emphasis added).

> An insider's duty to disclose information or his duty to abstain from dealing in his company's securities arises only in those situations which are essentially extraordinary in nature and which are reasonably certain to have a substantial effect on the market price of the security if [the extraordinary situation is] disclosed.[73]

An insider must be extraordinarily careful because he is charged with the responsibility of strictly observing the provisions of the Act and must bear the consequences for even an inadvertent miscalculation. Thus in one Fifth Circuit case it was observed that the objective standards left no room for inquiry into the question of the subjective intent of the insider or even whether he was actually trading on the inside information.[74]

Not surprisingly, complaints in some cases are couched in terms of both rule 10b-5 and section 16(b) violations. Thus, in *Lewis v. Adler*,[75] the court held that the complaint did not state a claim under rule 10b-5 because of a lack of sufficient allegations that the board of directors in question had been deceived or that material information had been withheld from it in connection with its grant of a stock option to an employee. But the individual defendant was held liable for profit on certain short-swing transactions, as exercise of his option was declared a "purchase" under section 16(b).[76]

Similarly, in *Levy v. Seaton*,[77] rule 10b-5 claims were dismissed as insufficient, while section 16(b) allegations would not have resulted in liability to the insider but for the absence of short-swing profit based on the date on which the option in question was first exercisable, and not the option price.

The greatest restriction on applicability of section 16(b) in coming years, however, will undoubtedly come not so much from a change of approach to that statute as from increasing reliance on rule 10b-5, with allowance of direct private actions, derivative actions, or both. Although in *Lewis* and *Levy*, causes of action were found under section 16(b) and not under rule 10b-5, allegations under 10b-5 will ordinarily afford the broader coverage despite the 10b-5 standard requiring *actual* misuse of inside information rather than the mere *possibility* of abuse under 16(b).

73. *Id.* at 848.
74. Keller Indus., Inc. v. Walden, 462 F.2d 388, 390 (5th Cir. 1972).
75. 331 F. Supp. 1258 (S.D.N.Y. 1971).
76. *Id.* at 1266. The Fifth Circuit has also held the exercise of a stock option to be a purchase. Keller Indus., Inc. v. Walden, 462 F.2d 388, 390 (5th Cir. 1972).
77. 358 F. Supp. 1 (S.D.N.Y. 1973).

CONCLUSION

The mechanical approach of determining applicability of section 16(b), sometimes resulting in "purposeless harshness" to the unsophisticated while failing to catch cunning insiders in its net, will no longer ordinarily be followed. Instead, the courts will look to the question whether the transaction could have lent itself to speculative abuse, showing that in the past 26 years progress has been made to a more reasonable, so-called "pragmatic" interpretation of the facts of each case to determine whether or not liability should properly be found in light of the plain purpose of the statute. What began as a simplistic, objective standard or rule of law has sensibly evolved into the more flexible standard of today.