10-1-1972

Securities Regulation -- A New Loophole in Section 16(b) -- An Insider's Delight

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Before 1934, corporate insiders were able to reap large profits by speculating in their own corporation’s securities because of their access to inside information.1 Section 16(b) of the Securities Exchange Act of 19342 was enacted to protect the interests of the public and other stockholders against such abuse.3 To accomplish this purpose, section 16(b) imposes strict liability for profits realized by any insider from a purchase and sale or sale and purchase accomplished within a six-month period.4 Insiders caught within section 16(b)’s scope of liability include officers, directors, and beneficial owners5 of more than ten percent of a corporation’s securities.

Since 1934, federal courts have struggled to apply the general terms6 of section 16(b) to the complex transactions revolving around corporate reorganizations, mergers, and other financial maneuvers involving securities. The United States Supreme Court has generally declined to get involved in this problem.7 However, in Reliance Electric Company v. Emerson Electric Company,8 the Court examined the ap-

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1See S. REP. No. 1455, 73rd Cong., 2nd Sess. 55 (1934).
315 U.S.C. § 78p(b) (1970). In addition this section is designed “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.” S. REP. No. 1455, 73rd Cong., 2d Sess. 68 (1934).
415 U.S.C. § 78p(b) (1970). Section 16(b) as follows:

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, or any sale and purchase, of any equity security of such issuer (other than an exempted security) within any period of less than six months, unless such security was acquired in good faith in connection with a debt previously contracted, shall inure to and be recoverable by the issuer, irrespective of any intention on the part of such beneficial owner, director, or officer in entering into such transaction of holding the security purchased or of not repurchasing the security sold for a period exceeding six months. . . . The 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. . . . (Emphasis added.)

5The 10% definition and filing requirements for such large stockholders are established by § 16(a), 15 U.S.C. § 78p(a) (1970).
6Terms in § 16(b) such as “purchase,” “sale,” and “equity security” are defined by § 3 in general terms also. See 15 U.S.C. § 78c(a)(11), (13)-(14) (1970).
7Prior to 1972, the only Supreme Court § 16(b) decision was Blau v. Lehman, 368 U.S. 403 (1961). For a discussion of this case, see text accompanying note 33 infra.
892 S. Ct. 596 (1972).
plication of section 16(b) to Emerson Electric Company, the corporate owner of 13.2 percent of the stock of another corporation, which had sold its entire holdings in two separate sales, both of which occurred within six months of the purchase. The Court, in a four-to-three decision, held that since the first of the two sales reduced Emerson’s interest to 9.96 percent, Emerson was not liable under section 16(b) for the profits derived from the second sale.

In Reliance, the sole issue was whether the second sale was within the scope of section 16(b)’s coverage in view of Emerson’s intent to escape liability by the split sale. The majority opinion, written by Justice Stewart, accepted the district court’s finding that Emerson had split its sale pursuant to a predetermined plan with the intent to avoid section 16(b) liability; however, the majority held that Emerson’s intent to avoid section 16(b) liability was irrelevant. In examining the objective requirements of section 16(b), the Court noted that a plan to sell that is conceived within six months of the purchase but carried out after six months has passed clearly would not result in liability. Hence, reasoned the majority, a plan to sell the remaining 9.96 percent did not result in liability merely because the sale was planned with intent to avoid liability while the owner owned more than ten percent. The Court based its decision on a literal interpretation of the requirement that a ten-percent beneficial owner be such both at the time of purchase and at the time of sale and on the congressional design of predicking liability on an objective standard, not the investor’s intent.

The dissent, written by Justice Douglas, noted that section 16(b) liability may exist regardless of an insider’s access to or intent to abuse inside information. The dissenters advocated a policy-oriented subjective approach of interpreting the terms of section 16(b) in the manner that—they felt—would best effectuate the purpose of the statute: They argued that the statute should be construed as allowing a rebuttable presumption that any such series of dispositive transactions are part of a single plan of disposition and hence should be treated as one sale.

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9Emerson did not appeal the court of appeals’ holding that Emerson was a 10% beneficial owner at the time of the purchase that enabled Emerson to become such. Id. at 598.

10Emerson had received written advice from its counsel that so splitting its sale could free the second sale from § 16(b) liability. Emerson Elec. Co. v. Reliance Elec. Co., 434 F.2d 918, 920-21 (6th Cir. 1970).

1192 S. Ct. at 599-600.

12Id. at 604-07. For a discussion of the subjective approach see text accompanying note 20 infra.
The seller's actual intent, the dissent pointed out, would be irrelevant. Instead, any factual inquiry would be limited to an objective analysis of the circumstances surrounding the sales and to whether the tests used in the policy-oriented subjective approach indicate that the sales fell within the terms of the statute. The dissenters rejected the majority's view that a ten-percent owner must literally be such both at the time of a purchase and at the time of a sale. Instead, they felt that the purpose of the ten-percent requirement is merely to establish the presumption that a ten-percent owner has access to inside information. Hence, an owner who acquires more than ten percent of a corporation's stock is "tainted" with inside information during the entire six-month period regardless of how he disposes of the stock.

Though there has been little litigation over the exact meaning of the requirement that ten-percent owners be such "both at the time of the purchase and sale,"¹³ the Reliance Court implicitly agreed with earlier lower court rulings that "at the time of" should be construed as "simultaneous with."¹⁴ Therefore, in the Reliance situation the first and second sales must be construed as "one sale" before section 16(b) applies. While both Justice Stewart and Justice Douglas agreed that the finding of "one sale" may not be predicated upon the ten-percent owner's intent, they disagreed as to what constitutes "one sale."

In answering this question, the majority in Reliance used the older objective-literal approach: The inquiry focused principally on whether the defendant's transactions could be characterized as a "purchase" or "sale" under section 16(b). If so, and both the purchase and sale were accomplished within six months, section 16(b) has been automatically applied regardless of the actual opportunity for abuse or speculative profit. The facts that the purchase or sale was involuntary and that the transactions were between entities controlled by the same interests without opportunity for profit made little difference.¹⁵

The Reliance majority felt that they could not adopt a subjective approach that "flatly contradicts the words of the statute."¹⁶ Hence, the

¹⁶ 92 S. Ct. at 601.
Court declined to construe the two separate sales as one despite the fact that an opportunity for insider profits existed in Reliance. The opinion did leave open the possibility of bringing within the scope of section 16(b) such a second sale were it proven to be legally or contractually connected to the first sale; however, the majority left undecided the standards for such "objective" proof.

As noted above, the minority in Reliance argued in favor of adopting the policy-oriented subjective approach in determining whether the split sale was one "sale" within the meaning of section 16(b). The initial and critical inquiry under this approach is whether the particular transaction and circumstances surrounding it presented opportunities for the type of abuse that section 16(b) was intended to prevent. The courts that have used this approach have agreed that no one factor or particular circumstance is necessarily conclusive; rather, all the circumstances surrounding the case must be considered. For example, in Roberts v. Eaton, one of the first cases in which the subjective approach was employed, the Second Circuit Court of Appeals held that a reclassification of stock was not a "purchase." Even though the owner had realized a profit on a sale of the new shares within a month of the reclassification, the Roberts court found that no possibility of speculative abuse existed since the owner's proportional interest had remained unchanged and there had been full disclosure of the owner's intent to sell before the shareholders had ratified the reclassification.

The policy-oriented subjective approach has also been used to extend section 16(b)'s scope to cover transactions not normally thought of as purchases or sales where the court found that the transaction

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18 See 92 S. Ct. at 600.
19 For a good discussion of this point see Note, Securities Regulation—Securities Exchange Act Section 16(b)—Owner of More than Ten Percent of Issuer's Stock, Who Reduces His Holdings Below Ten Percent in One Sale With Intent to Avoid Liability for Short-Swing Profits, Does Not Have to Disgorge Profits Derived From Subsequent, "Legally" Unrelated Sales of Remaining Shares Within the Same Six-Month Period, 5 GA. L. REV. 584, 589-90 (1971).
22 The Roberts court also relied upon the facts that the new issue's value was related to the value of the corporation, that the owner had no more knowledge than the public about how the new issue would be accepted on the market, and that any increase in value was fortuitous. Id. at 85.
would lend itself to speculative abuse. Thus, in Newmark v. RKO General, Inc.,\textsuperscript{23} the Second Circuit held that an exchange of stock for new stock pursuant to a merger agreement was a "sale." The Newmark court viewed as critical the fact that the owner of an option to purchase shares that were later exchanged had control over the approval of a subsequent merger agreement and stood to gain insider's profits.\textsuperscript{24}

The crucial test in all such cases seems to be whether the possibility of speculative abuse did in fact exist. In Abrams v. Occidental Petroleum Corp.,\textsuperscript{25} the Second Circuit reversed a district court holding\textsuperscript{26} on the basis that the possibility of speculative abuse by a ten-percent owner did not exist. The Abrams court re-examined the circumstances surrounding the granting of an option and the involuntary exchange of stock pursuant to a merger agreement and held that neither of these two transactions were "sales" within the meaning of section 16(b).\textsuperscript{27}

The minority in Reliance insisted that there is a strong statistical probability that any series of sales made by a ten-percent owner within six months in which he disposes of most of his holdings is likely to be part of a single plan of disposition.\textsuperscript{28} Since the possibility of abuse did in fact exist, the majority and minority opinions clash over the question of whether to rely solely on the objective definitions of the statute or on the subjective surrounding factors.

It seems clear from the case law that the majority of courts had adopted the policy-oriented subjective approach;\textsuperscript{29} however, the Reliance decision certainly has limited its application. Without overruling any previous cases, the Reliance Court has in effect proclaimed that

\textsuperscript{24}The optionee in this case exercised the option before merger plans were finalized and disclosed to the public, and the exchange occurred within six months. \textit{Id}.
\textsuperscript{25}450 F.2d 157 (2d Cir. 1971).
\textsuperscript{26}The district court had held that the granting of an option was a "sale" based on the finding that the "insider," which had become a ten-percent owner in an unsuccessful attempt to gain control of the issuer corporation, could use its influence and inside knowledge to oppose take-over attempts by others or to induce the issuer or its successor to buy its stock at a profit to the insider. 323 F. Supp. 570, 574-75 (S.D.N.Y.), rev'd, 450 F.2d 157 (2d Cir. 1971).
\textsuperscript{27}450 F.2d at 163-65. The Abrams court distinguished Newmark on the differences in influence and control which the ten-percent owner had over the merger. As to the option, the Abrams court viewed as critical its finding that the option was a straight-forward business agreement. \textit{Id}.
\textsuperscript{28}For a general discussion of the problem of when stock options are purchases see Comment, 47 \textsc{Texas L. Rev.}, \textit{supra} note 20, at 1431-34.
\textsuperscript{29}See 5 L. Loss, \textsc{Securities Regulation} 3037 (Supp. 1969). See also Lowenfels, \textit{supra} note 15.
the subjective approach is viable only "where alternative constructions of the terms of § 16(b) are possible." The Court rejected the subjective approach in Reliance because Congress had included the express provision that a ten-percent owner must be such at both the time of the purchase and the time of the sale. It has been argued that Congress added this provision to prevent inclusion of stock owners who did not in fact have the presumed access to inside corporate information. Perhaps the subjective approach was rejected because it could lead to harsh results: As the majority conceded, it would be difficult to rebut the presumption that a series of dispositive transactions afforded the owner an opportunity for speculative abuse as an insider.

Both opinions in Reliance acknowledged that Congress intended the application of Section 16(b) to be based on objective criteria. In Blau v. Lehman, the Supreme Court also refused to use the subjective test to extend the definition of "director" merely because of a potential for abuse. However, in Lehman the Court's dictum left open the possibility that subjective proof could be used to establish agency or "deputization" whereby a corporation itself would be deemed a "director" when one of its personnel acts as a director in another corporation.

The Court in Reliance was concerned with the substance of the transaction in question (the split sale) and not the intent on Emerson's part to buy or sell within a six-month period. Using the subjective approach, Emerson's intent to split the sale could have been viewed merely as an evidential factor for the court to consider in determining whether the transaction was actually one "sale" within the meaning of section 16(b). Such a finding would then have satisfied the provision requiring that a ten-percent beneficial owner be such "at the time of" the sale. One who is classified as a ten-percent owner within the meaning of section 16(b) automatically incurs liability for profits derived from a sale within six months of a purchase regardless of his intent at the time.
of purchase. Thus Congress intended the statute to apply mechanically.\textsuperscript{35}

Alternatively, the \textit{Reliance} Court could have used the policy-oriented subjective approach which would have permitted consideration of the substantial effect and the circumstances surrounding the transaction in question.\textsuperscript{36} Such an approach would have allowed the majority in \textit{Reliance} to come to the same decision had it determined that Emerson had not in fact had an opportunity to abuse inside information.\textsuperscript{37} Hence, the harsh application of section 16(b) suggested by the minority opinion in \textit{Reliance} could be avoided while the flexibility of the subjective approach would be available for similar future cases.

The \textit{Reliance} decision provides a definite loophole whereby a statu-

\textsuperscript{35}Arguably, the intent to buy and sell within a six-month period is the only intent that is irrelevant under \S\ 16(b). In hearings before the Senate Committee on Banking and Currency prior to enactment of the Securities and Exchange Act of 1934, Mr. Thomas G. Corcoran, a principal draftsman of the Act and its chief spokesman before Congress, testified with respect to \S\ 16(b):

\begin{quote}
You hold the director, irrespective of any intention or expectation to sell the security within six months after, because it will be absolutely impossible to prove the existence of such intention or expectation, and you have to have this crude rule of thumb, because you cannot undertake the burden of having to prove that the director intended, at the time he bought, to get out on a short swing.
\end{quote}

A subjective standard of proof, requiring a showing of an actual unfair use of inside information, would render senseless the provisions of the legislation limiting the liability period to six months . . .

\textit{Hearings on Stock Exchange Practices Before the Senate Comm. on Banking and Currency,} 73rd Cong., 2d Sess. 6557 (1934); see Blau v. Allen, 163 F. Supp. 702, 705 (S.D.N.Y. 1958); Bateeman, \textit{The Pragmatic Interpretation of Section 16(b) and the Need for Clarification,} 45 \textit{St. John's L. Rev.} 772, 793 (1971); Lowenfels, \textit{supra} note 15, at 61.

\textsuperscript{36}After discussing the purpose of \S\ 16(b), the Seventh Circuit in Bershad v. McDonough, 428 F.2d 693, 697 (7th Cir.), \textit{cer. denied}, 400 U.S. 992 (1970) stated:

\begin{quote}
The phrase "any purchase and sale" in Section 16(b) is therefore not to be limited or defined solely in terms of commercial law of sales and notions of contractual rights and duties (citations omitted). Applicability of this Section may depend upon the factual circumstances of the transaction, the sequence of relevant transactions, and whether the insider is "purchasing" or "selling" the security. . . . The insider should not be permitted to speculate with impunity merely because of the paper form of his transactions.
\end{quote}

The court went on to note that the commercial substance of the transaction should be examined. \textit{Id.}

\textsuperscript{37}See Abrams v. Occidental Petroleum Corp., 450 F.2d 157 (2d Cir. 1971). It should be noted that the \textit{Reliance} Court might have found the split sale not a sale within the meaning of \S\ 16(b) on the basis of the involuntary nature of the sale. See, e.g., Petteys v. Butler, 367 F.2d 528 (8th Cir. 1968), \textit{cert. denied}, 385 U.S. 1006 (1967). Arguably the sale in \textit{Reliance} was involuntary because many mergers are completed within six months, R. MUNDBEIM, A. FLEISCHER, \& D. GLAZER, \textit{First Annual Institute on Securities Regulation} 283 (1970), and the completion of the merger may very likely also be a sale. \textit{Id.} at 286; e.g., Newmark v. RKO Gen., Inc., 425 F.2d 348 (2d Cir.), \textit{cert. denied}, 400 U.S. 854 (1970).
tory insider may now dispose of his last 9.9 percent in a legally separate sale within six months of the purchase and retain any profits realized. Hence, the profit motive has been at least partially returned to a beneficial owner who wishes to engage in short-term speculation with the aid of inside information. However, this loophole may be somewhat illusory. Ten-percent beneficial owners are fiduciaries in the same sense as are directors and officers, and section 16(b) was enacted to prevent the abuse of this relationship. But recent judicial development in federal and state law has caused the demise of section 16(b) as the sole remedy for such abuse. The federal courts have begun to develop another remedy by extending the definition of common law fraud under rule 10b-5 to include the failure to disclose material information by either a purchaser or a seller in a transaction. A cause of action under rule 10b-5 thus may become the principal means of barring speculative abuse of confidential corporate information by insiders since rule 10b-5 has none of the restrictions that circumscribe the application of section 16(b).

In *Diamond v. Oreamuno,* the Court of Appeals of New York held that although section 16(b) might not apply, a stockholder's derivative action could be maintained under state law to deal with the abuse of a fiduciary relationship by an insider who had actually used corporate information for his own benefit, even though the corporation had not been injured. The primary concern of the court in this case was who had the more legitimate claim to the proceeds derived from the exploitation of inside information.

In conclusion, it seems that the Court's decision has unnecessarily restricted the Court's flexibility to employ the subjective approach, and thereby the policy underlying section 16(b) has been thwarted. Perhaps this decision, in light of newer developing remedies, is a harbinger of a new reluctance to apply the subjective approach to expand the scope of section 16(b) liability beyond its literal meaning.

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