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Ninth Circuit Review—Beneficial Owner's Liability for Short-Swing Profits: Judicial Construction of Section 16(b)'s Exemption Provision

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BENEFICIAL OWNER'S LIABILITY FOR SHORT-SWING PROFITS: JUDICIAL CONSTRUCTION OF SECTION 16(b)'s EXEMPTION PROVISION

To facilitate liquidation and dissolution, Provident Securities Company (Provident) agreed to sell two-thirds of its assets to Foremost-McKesson, Inc. (Foremost) for $54,000,000.00.[1] After protracted negotiations an agreement was reached whereby Provident would receive $4,250,000 cash and $49,750,000 in six percent, convertible subordinated debentures issued by Foremost.[2] As provided in the purchase agreement, however, such debentures were not marketable without prior written consent of Foremost unless registered under the Securities Act. Foremost satisfied this registration requirement by filing an amended Form S-1 registration statement[3] with the Securities and Exchange Commission regarding the sale of $25,000,000 of the aggregate principal amount of the debentures.[4]

One week after the closing of the purchase agreement, an underwriting agreement covering the $25,000,000 aggregate principal amount of the debentures was executed by Foremost, Provident, and as representative of the underwriting group, Dillion, Read & Company.[5] Pursuant to the underwriting agreement, delivery of $25,366,666.66 was made to

1. Provident Sec. Co. v. Foremost-McKesson, Inc., 506 F.2d 601, 603 (9th Cir. 1974), *cert. granted*, 95 S. Ct. 1117 (1974).

2. Foremost-McKesson, for various reasons, including its desire to acquire liquid assets in order to pursue other acquisitions, wanted to pay the major portion of the purchase in its own securities issued expressly for that purpose. Provident argued that if Foremost wanted to use securities to finance the purchase, it should sell them itself and make payment to Provident in cash. Brief for Appellee at 3, Provident Sec. Co. v. Foremost-McKesson, Inc., 506 F.2d 601 (9th Cir. 1974), *cert. granted*, 95 S. Ct. 1117 (1975) [hereinafter cited as Brief for Appellee].

3. Form S-1 is used to register the securities of all issuers under the Securities Act of 1933, 15 U.S.C. § 77a *et seq.* (1970). Its purpose is to inform investors of all material information regarding the issuance. In general, Form S-1 requires disclosure of the following information: (Part One) distribution spread (price to the public, underwriting discounts, and commissions, proceeds to registrant), distribution plan, use of proceeds by registrant purpose of the distribution, capital structure, summary of earnings, organizational identifications, stock description, principal holders of securities; (Part Two) marketing arrangements, sales to special parties, recent sales of unregistered stock, accompanying financial statements. *See* Securities Act of 1933, § 7, 15 U.S.C. § 77g (1970).

4. Form S-1 was filed with the SEC on September 29, 1969. Brief for Appellee, *supra* note 2, at 6.

5. Brief for Appellee, *supra* note 2, at 9.

Provident in exchange for the debentures. Subsequent to the realization of the $366,666.66 profit, and in view of the fact that the debentures were immediately convertible into common stock in an amount greater than ten percent of Foremost's outstanding shares, Provident sought a declaratory judgment as to its liability[6] for short-swing profits under section 16(b) of Securities Exchange Act of 1934.[7]

In order to prevent the unfair use of inside information[8] by statutory insiders,[9] section 16(b) provides that any profits realized from the purchase and sale of equity securities within a six-month period, by any owner of more than ten percent of any class of such securities[10] is conclusively presumed to be derived from inside information. Thus, the

6. Under section 16(b) of the Act, 15 U.S.C. § 78p(b) (1970), a shareholder who has determined that there has been a violation of the section must notify the corporation and afford it an opportunity to bring an action. If no such action is brought within sixty days of notification, the shareholder may bring a derivative action. The Securities and Exchange Commission, thus, does not play the same type of role that it does in section 10(b) litigation.

7. Section 16(b), 15 U.S.C. § 78p(b) (1970) provides:

> For the purpose of preventing the unfair use of information which may have been obtained by [a] beneficial owner, director, or officer by reason of his relationship to the issuer, 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.

Section 16(b) should be read in conjunction with section 16(a) 15 U.S.C. § 78p(a) (1970), which provides the means for discovering a violation of section 16(b):

> Every person who is directly or indirectly the beneficial owner of more than 10 per centum of any class of any equity security . . . or who is a director or an officer of the issuer of such security, shall file . . . a statement with the Commission . . . of the amount of all equity securities of such issuer of which he is the beneficial owner. . . .

8. For purposes of this discussion, inside information is any data regarding any corporate matter, acquired by reason of the recipient's relationship to the issuer, and which is not available to the investing public.

9. For purposes of section 16(b), a statutory insider includes a "beneficial owner, director, or officer who has access to insider information "by reason of his relationship to the issuer."

10. The term "equity security" means any stock or similar security; or any security convertible, with or without consideration, into such a security, or carrying any warrant or right to subscribe to or purchase such a security; or any such warrant or right; or any other security which the Commission shall deem to be of similar nature and consider necessary or appropriate, by such rules and regulations as it may prescribe in the public interest or for the protection of investors, to treat as an equity security.

15 U.S.C. § 78c(11) (1970).

section mandates that any profits realized[11] be forfeited to the issuer, irrespective of the beneficial owner's intention in regard to such purchase and sale. The conclusive presumption, that the transaction was based upon inside information, has the effect of lessening the burden of proving actual misuse[12] of information, necessary in the application of rule 10b-5.[13]

11. Section 16(b) reaches only the

> "profit realized by him [*i.e.*, the beneficial owner] from any purchase and sale, or any sale and purchase of any equity security . . . ." Since profit on purchased stock is not "realized" until its sale, this—the operative clause of the Section—standing alone might be read as applying to profit realized by a person who was a "beneficial owner" at the time of his sale, irrespective of his status as a beneficial owner at the time of his prior purchase of the stock.

Stella v. Graham-Paige Motors Corp., 232 F.2d 299, 303 (2d Cir.) (Hincks, J., dissenting), *cert. denied*, 352 U.S. 831 (1956). Based on Judge Hincks's interpretation, it would appear that the entire transaction encompassed by section 16(b) must be read as one transaction, including both the sale and the purchase, or the purchase and sale. See text accompanying notes 62-67 *infra.*

12. Intent and motive under section 16(b) are inapplicable as defenses to actions seeking disgorgement of resulting short-swing profits. The presumption created by section 16(b) is conclusive insofar as it regards the intention or expectation of speculative abuse based on inside information. *See* Reliance Elec. Co. v. Emerson Elec. Co., 404 U.S. 418 (1972) (Douglas, J., dissenting); Provident Sec. Co. v. Foremost-McKesson, Inc., 506 F.2d 601 (9th Cir. 1974), *cert. granted,* 95 S. Ct. 1117 (1975). This conclusive presumption should be distinguished from the section's presumption that "officers, directors and 10-percent shareholders fall within the class of persons who may reasonably be expected to have access to inside information . . . ." 506 F.2d at 612. This latter presumption is rebuttable. Kern County Land Co. v. Occidental Petroleum Corp., 411 U.S. 582 (1973).

Although it does not appear that the question has yet been raised in any judicial proceeding, it might be argued that the conclusive presumption created by section 16(b) is unconstitutional in its across-the-board application. *See* Cleveland Bd. of Educ. v. LaFleur, 414 U.S. 632 (1974); Department of Agric. v. Murry, 413 U.S. 528 (1973); Vlandis v. Kline, 412 U.S. 441 (1973). In those cases, the Court invalidated state statutes with presumptions similar to that of section 16(b), on due process, rather than equal protection, grounds. Since it is possible that a person could acquire more than ten percent of an issuer's securities without having had inside information, it would appear that the section is over-inclusive. Conversely, a person who has acquired more than ten percent of an issuer's securities, on the basis of inside information, but does not make a sale of such securities until one day after six months from the time of purchase, would not be held liable under the section. Another instance in which the section would appear to be under-inclusive, is *Provident's* reading of "at the time of" as meaning "prior to." It is possible that a person might have had inside information prior to the acquisition giving him ten percent ownership but would not be held liable. Under such circumstances, it could be argued that the statute is under-inclusive. Further, to treat the above mentioned instances as subject to section 16(b) would be contrary to the express purpose of the section which is designed to prevent abuses of inside information obtained because of one's relationship to the issuer. *But see* Weinberger v. Salfi, 422 U.S. 749 (1975).

It has been suggested that the presumption of section 16(b) be amended to provide a rebuttable presumption that there was an abuse of inside information for any transactions, by a beneficial owner, within one year. Munter, *Section 16(b) of the Securities Exchange Act of 1934: An Alternative to "Burning Down the Barn in Order to Kill the Rats,"* 52 CORNELL L.Q. 69 (1966) [hereinafter cited as Munter].

In examining both the purpose behind the statute and the abuses it sought to prevent, the district court in *Provident Securities v. Foremost-McKesson, Inc.*[14] agreed with those courts which "have not felt required to apply §16(b) in all cases regardless of concomitant equities and circumstances," and rejected a mechanical application of the rule.[15] Based upon the facts presented, in particular that Foremost had controlled the essential details of the transaction, the court found there existed no real potential for speculative abuse of inside information.[16] The court concluded:

> To allow Foremost under these circumstances to recover the small profit . . . simply by a mindlessly literal application of Section 16(b) would be to perpetuate rather than correct an inequity.[17]

On appeal, the Ninth Circuit disagreed with the district court's determination that there was no potential for speculative abuse.[18] Nonetheless, it affirmed the decision on the ground that Provident was not within the class of persons to whom section 16(b)'s conclusive presumption was intended to apply.[19] The court adopted the position that the purchase by

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13. Rule 10b-5 provides:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails, or of any facility of any national securities exchange,
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> (a) To employ any device, scheme, or artifice to defraud,
>
> (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading, or
>
> (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

17 C.F.R. 240.10b-5 (1973). Rule 10b-5, which requires an actual showing that a person has violated the statute, is available as a cause of action for abuses of inside information not actionable under section 16(b). *See* Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 495 F.2d 228 (2d Cir. 1974); Mitchell v. Texas Gulf Sulphur Co., 446 F.2d 90 (10th Cir.), *cert. denied*, 404 U.S. 1004 (1971); SEC v. Texas Gulf Sulphur Co., 401 F.2d 833 (2d Cir. 1968), *cert. denied*, 394 U.S. 976 (1969); Cady, Roberts & Co., 40 SEC 907 (1961).

14. 331 F. Supp. 787 (N.D. Cal. 1971), *aff'd on other grounds*, 506 F.2d 601 (9th Cir. 1974), *cert. granted*, 95 S. Ct. 1117 (1975).

15. *Id.* at 791. The court further stated:

> "We believe that each case must be examined on its own facts and [Section 16(b)] only applied when these facts disclose the possibility of abuses that the Act were [*sic*] designed to prevent."

Id., *quoting* Petteys v. Butler, 367 F.2d 528, 533 (8th Cir. 1966).

16. *Id.* at 792.

17. *Id.*

18. 506 F.2d 601, 605 (9th Cir. 1974), *cert. granted*, 95 S. Ct. 1117 (1975).

19. *Id.* at 614. The court initially examined the question of when the sale of the debentures was completed. Stating that such a determination for purpose of section 16(b)

which one becomes a ten percent beneficial owner may not form the basis for the application of the section, even though a profitable sale occurs within six months. In so holding, the Ninth Circuit adopted a position that differs sharply with the Second[20] and Eighth Circuits.[21]

A prerequisite to the proper application of section 16(b) is an understanding of legislative intent underlying the statute. In its embryonic stages section 16(b) was only intended by its drafters to be a "crude rule of thumb."[22] It was not intended to prevent all abuses of inside information,[23] but rather, only those abuses "which may have been obtained by such beneficial owner, director, or officer by reason of his relationship to the issuer. . . ."[24] Thus, if the transactor is not an insider, his "outsider" status bars the opportunity for speculative abuse prohibited by the section and removes the transaction from the section's purview.

To effectuate this congressional intent, close scrutiny has been given to the provision of section 16(b) which specifically exempts any transac-

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is to be decided according to federal law, the court relied on other cases which had sought to determine at what point "the insider ha[d] relinquished his ability to control the transaction to the extent that he no longer has the potential to use inside information . . . ." *Id.* at 606, *citing* Booth v. Varian Associates, 334 F.2d 1 (1st Cir. 1964), *cert. denied,* 379 U.S. 961 (1965). Accordingly, since Provident became bound on October 21, by the terms and conditions of the agreement, the sale was completed on that date. The purchase and sale therefore occurred within six months. *Id.* at 607.

20. *See* Perine v. William Norton & Co., 509 F.2d 114 (2d Cir. 1974); Newmark v. RKO General, Inc., 425 F.2d 348 (2d Cir. 1969), *cert. denied,* 400 U.S. 854 (1970); Stella v. Graham-Paige Motors Corp., 232 F.2d 299 (2d Cir.), *aff'g in part and remanding in part,* 132 F. Supp. 100 (S.D.N.Y. 1955), *recognizing as the law of the case* 104 F. Supp. 957 (S.D.N.Y. 1952), *cert. denied,* 352 U.S. 831 (1956).

21. Emerson Elec. Co. v. Reliance Elec. Co., 434 F.2d 918 (8th Cir. 1970), *aff'd* 464 U.S. 418 (1972). *But see* Arkansas Louisiana Gas Co. v. W.R. Stevens Inv. Co., 141 F. Supp. 841 (W.D. Ark. 1956), where it was held that where an investment company which owned more than ten percent of the stock in a gas company purchased stock in the gas company at prevailing market prices and in turn filled orders of customers, the transactions were purchases and sales within the provision of the Securities Exchange Act authorizing recovery of profit made by officers, directors or shareholders of the corporation from short-term trading in the corporate securities. *Id.* at 841. In deciding whether the original purchase should be used in computing recoverable profits, the court cited Judge Hincks's dissent in Stella v. Graham-Paige Motors Corp., 232 F.2d 299, 302 (2d Cir. 1956) (*see* text accompanying notes 60-61 *infra*), and thus concluded that the original purchase should not be considered in computing the recoverable profits.

22. *Hearings on S. Res. 84, S. Res. 56 and S. Res. 97 Before the Senate Comm. on Banking and Commerce,* 73d Cong., 1st Sess. 6557 (1934) (testimony by Mr. Thomas G. Corcoran) [hereinafter cited as *Hearings*]. The *Provident* District Court also called it an "extremely crude rule of a most deformed and misshapen thumb." 331 F. Supp. at 792.

23. *See* notes 41-47, 50-61 *infra* and accompanying text.

24. 15 U.S.C. § 78p(a) (1970).

tion by beneficial owners[25] holding less than a ten percent interest "both at the time of the purchase and sale." The specific issue examined by the *Provident* court was whether the initial purchase of at least ten percent of an issuer's outstanding shares will subject the purchaser to liability under the section upon a subsequent profitable sale. Although the subject of numerous law review articles,[26] the correct construction of the exemption provision has been analyzed by only a handful of cases.

The first decision construing the phrase "at the time of" was *Stella v. Graham-Paige Motors Corporation.*[27] The court found that the phrase was to be interpreted as ownership "simultaneously with" the purchase and sale. There, the defendant-corporation had considerable holdings in Kaiser-Frazer Corporation, which were reduced below ten percent of the outstanding shares by issuances subsequent to defendant's original acquisition. Thereafter, an additional acquisition once again conferred beneficial ownership status on Graham-Paige. Less than six months later, defendant sold a portion of its holdings, but still maintained beneficial ownership status. A stockholder of Kaiser-Frazer brought suit for violations of section 16(b) to recover the profits realized.

The defendant contended that the language "at the time of" required

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25. While section 16(b) is applicable to directors, officers and beneficial owners, the exemption provision applies only to beneficial owners. *See* Adler v. Klawans, 267 F.2d 840 (2d Cir. 1959) (one who is a director at the time of sale need not also have been a director at the time of purchase). In deciding whether an investor is an officer or director within the meaning of section 16(b), courts have allowed proof that the investor performed the functions of an officer or director even though not formally denominated as such. Colby v. Klune, 178 F.2d 872, 873 (2d Cir. 1949); *cf.* Feder v. Martin Marietta Corp., 406 F.2d 260, 262-63 (2d Cir. 1969). The various tests employed in these cases are used to determine whether a transaction falls within or without the terms of the statute. In no case is liability predicated upon "considerations of intent, lack of motive, or improper conduct" which are irrelevant in section 16(b) actions. Blau v. Oppenheim, 250 F. Supp. 881, 887 (S.D.N.Y. 1966). *See* note 12 *supra.* For a discussion of the liability of officers and directors under section 16(b) see Meeker & Cooney, *The Problem of Definition in Determining Insider Liabilities under Section 16(b)*, 45 VA. L. REV. 949 (1959); Wentz, *Refining a Crude Rule: The Pragmatic Approach to Section 16(b) of the Securities Exchange Act of 1934*, 70 NW. U.L. REV. 221, 253-60 (1975) [hereinafter cited as Wentz]; Yourd, *Trading in Securities by Directors, Officers and Stockholders: Section 16 of the Securities Exchange Act*, 38 MICH. L. REV. (1939).

26. *See* Munter, *supra* note 12; Note, *Is the Purchase By Which One Becomes a Ten Percent Beneficial Owner a Statutory Purchase Within the Meaning of Section 16(b)?*, 7 RUTGERS-CAM. L.J. 104 (1975); Note, *Short-Swing Profits and the Ten-Percent Rule*, 9 STAN. L. REV. 582 (1957); Comment, *Section 16(b): An Alternative Approach to the Six-Month Limitation Period*, 20 U.C.L.A.L. REV. 1289 (1973).

27. 104 F. Supp. 957 (S.D.N.Y. 1952), *recognized as law of the case*, 132 F. Supp. 100 (S.D.N.Y. 1955), *aff'd in part and remanded in part*, 232 F.2d 299 (2d Cir.), *cert. denied*, 352 U.S. 831 (1956). For comments on the *Stella* case, see 57 COLUM. L. REV. 287 (1957); 70 HARV. L. REV. 1312 (1957).

that when 16(b) liability is predicated upon a purchase/sale transaction, beneficial ownership status must exist *prior to* the initiating transaction. The court rejected this contention,[28] holding instead that section 16(b) includes a transaction where the purchase leading to the short-swing profit is also the very purchase which makes the stockholder a ten percent owner.[29] According to its interpretation, the language of 16(b) only requires that beneficial ownership exist "simultaneously with" both the purchase and sale.[30] "Simultaneously with" does not require an individual, once he or she is a ten percent owner, to make another purchase and then a sale for liability to attach. Since the defendant owned ten percent both at the time of the initial purchase and subsequent sale, liability could attach within the meaning of the section.

The court noted that the section itself fails to qualify "at the time of," but nonetheless thought the congressional intent underlying the enactment of the section was clear in evidencing a purpose of protecting outside stockholders against short-swing speculation by insiders with advance information.[31] The court supported its decision by reference to a hypothetical. However, while the reasoning evidenced by this application appears facially sound, the hypothetical raises a problem inherent in the *Stella* interpretation of "at the time of."

The court posited that a situation could exist where an individual purchasing more than ten percent and selling his holdings to below ten percent, repeating the process ad infinitum, would not be subject to liability since prior to each purchase he was not a ten percent owner.[32]

28. 104 F. Supp. at 959.

29. *Id.* at 960.

30. *Id.*

31. *Id.* at 959. In so concluding, the court relied on two prior cases: Shaw v. Dreyfus, 172 F.2d 140 (2d Cir. 1949) and Park & Tilford, Inc. v. Schulte, 160 F.2d 984 (2d Cir. 1947). In *Shaw*, it was contended that a stockholder's receipt of rights by virtue of corporate resolution was a "purchase" of such rights within the intent of section 16(b). This argument was denied. The court noted that the statute's purpose was to protect the outside stockholders against at least short-swing speculation by insiders with advance information. Inside information which the directors might have had could not possibly have been used to the detriment of other stockholders. In voting to grant rights to all stockholders of record in proportion to their existing holdings, all were treated equally. 172 F.2d at 142. In *Schulte*, the court was involved with majority stockholders' conversion, pursuant to an option contained in their preferred stock, of preferred shares into common, followed by a sale within six months. In holding that this constituted an "acquisition, purchase and sale" within the Act, the court pointed out that the congressional purpose behind the section was to protect the outside stockholder against at least short-swing speculation by insiders with advance information. 160 F.2d at 987. *But see* Blau v. Lamb, 363 F.2d 507 (2d Cir. 1966); Ferraiolo v. Newman, 259 F.2d 342 (6th Cir. 1958), *cert. denied*, 359 U.S. 927 (1959).

32. 104 F. Supp. at 959.

In the court's hypothetical situation, however, the shareholder's beneficial ownership status terminated with the closing transaction. Under the *Stella* analysis, which construes the terms "both at the time of purchase and sale" as meaning simultaneously with both the purchase and sale, an individual who is a ten percent owner and who sells down to below ten percent could not be held liable since "simultaneously with" the sale he was not a beneficial owner. This anomaly was specifically noted by the court in *Emerson Electric Co. v. Reliance Electric Co.*[33]

There, Emerson Electric Company had acquired 13.2 percent ownership in Dodge, a small manufacturing concern, as part of its attempt to block a proposed merger between Dodge and Reliance. When the merger was approved, Emerson liquidated its holdings in two separate sales, the first of which reduced its ownership to below ten percent.[34] Both sales occurred within six months of the initial acquisition and Reliance brought suit for violation of section 16(b). While the court concluded that no liability derived from the second sale,[35] it did impose liability for the profits realized by the first sale.[36]

In so holding, the court adopted the *Stella* position that "at the time of" did not mean "prior to," but "simultaneously with" the purchase. It agreed with *Stella* that a purchase by which one becomes a ten percent shareholder is within section 16(b).[37] Liability was imposed on Emerson, notwithstanding the fact that it was not a beneficial owner simultaneously with the *sale* as that phrase was defined in *Stella*.[38] The court

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33. 434 F.2d 918 (8th Cir. 1970), *aff'd* 404 U.S. 418 (1972). When *Emerson* was before the Supreme Court, it was noted there was an issue as to the proper definition of "at the time of," but the Court did not decide this issue. 404 U.S. at 421.

34. 434 F.2d at 921.

35. *Id.* at 926. In finding no liability attached to the second sale, the court applied the section literally. First, the court noted that a person may purposely avoid the proscription of section 16(b) by selling down to below ten percent without incurring liability. Second, the court could not find any congressional intention which would require it to treat the two sales as one transaction. The court stated:

> [W]e have determined as a matter of law that intent as such to avoid loss of realized profits by engaging in two independent sales not legally tied to each other and made at different times to different buyers . . . does not result in treating the two sales as one sale of the entire stock held, nor as one continuous transaction . . . .

Id. This portion of the *Emerson* holding was affirmed by the Supreme Court over a strong dissent by Justice Douglas. 404 U.S. at 427 (1972). The language of the circuit court implicitly left open the question of whether two sales made either at the same time or to the same buyer could be considered as one transaction.

36. 434 F.2d at 923, 924.

37. *Id.* at 923.

38. One might argue that such an individual is a beneficial owner "simultaneously with" the sale. However, as that phrase was applied to the purchases in *Stella* and

did not appear to be bothered by the fact that *Stella* was an express rejection of a "prior to" interpretation and created a question of whether one is a beneficial owner at the time of a closing sale when such sale terminates beneficial ownership status.

Without expressly dealing with the issue, the court resolved the problem by first noting that "at the time of" could have several meanings.[39] It then reasoned:

> It is doubtful that Congress intended [the phrase] to have one of those meanings in every situation. Therefore, without departing from the statute the words "at the time of" might mean "immediately before" in the case of a purchase and "simultaneously with" in the case of a repurchase.[40]

In view of this, it interpreted the *Stella* court to hold that "simultaneously with" in regards to a purchase meant just after the purchase and just before the sale.

Against this background of previous judicial interpretations, the *Provident* court was confronted with a situation where an initial purchase conferred beneficial ownership status and the subsequent sale resulted in a total divestiture of the stock holdings. As in *Stella* and *Reliance,* the court looked to the congressional intent behind the enactment of section 16(b) for guidance in determining if the initial transaction could give rise to the application of the section.[41] The court noted that

> the section was designed to deter insiders from purchasing stock without any intention of making a long-term investment, but only with the intention of profiting from upward fluctuations in the market price that were predictable on the basis of inside information.[42]

Therefore, the court concluded that liability under the section could attach only when a person could be presumed to have had inside information in making the decision as to both the initial and closing transactions.

The court then examined the presumption created by section 16(b),

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Emerson, it in effect means "immediately after." As noted by the Seventh Circuit in Allis-Chalmers Mfg. Co. v. Gulf & Western Indus., Inc., CCH 1975 FED. SEC. L. REP. ¶ 95,308, at 98,550-01 n.8 (7th Cir. Sept. 29, 1975), there is no distinction between "simultaneously with" and "immediately after."

39. "[The phrase] may refer to a condition existing either 'immediately before,' 'simultaneously with' or 'immediately after' a given event." 434 F.2d at 922-23.

40. *Id.* at 923 (footnote omitted).

41. 506 F.2d at 609-14.

42. *Id.* at 609.

positing that a proper application of this presumption was in accord with its interpretation that "at the time of" meant "prior to." The congressional intent, the court believed, made it clear that the presumption under the section was to arise only when one has substantial stockholdings and, thus, could be said to have obtained inside information by "reason of his relationship to the issuer."[43] Furthermore, since the presumption under the section is conclusive, the class of persons deemed to be insiders under the statute must be narrowly construed.[44]

Since one who is an outsider prior to the initial transaction cannot be said to have had inside information,[45] it is necessary to first determine whether the person had the status of an insider prior to the initial transaction. If such status exists and if the person engages in a closing transaction within six months,[46] then such person is conclusively presumed to have acted on the basis of his relationship to the issuer, and thus on the basis of inside information.[47] Since the *Provident* court determined that at the time of its initial transaction Provident was not a statutory insider, it necessarily followed that it did not act on the basis of inside information *both* at the time of the purchase and sale.

While the court's conclusion that "at the time of" required a person to be a beneficial owner "prior to" the initiating transaction disposed of the issue of Provident's liability, the court went on to clarify its holding. Recognizing that its interpretation "should not be applied to a transaction that is not an initial purchase but in reality is a repurchase or a closing transaction,"[48] the court made it clear that the term "prior to" was to be applied only to the initiating transaction, whether a purchase or a sale. The court emphasized that this "prior to" interpretation was not to be applied to closing transactions. Rather, in the context of such transactions, "at the time of" should be interpreted to mean "simultaneously with."[49]

43. *Id.* at 614. *See* Note, *Short-Swing Profits and the Ten-Percent Rule*, 9 STAN. L. REV. 582 (1957).

44. 506 F.2d at 611. *See also* notes 12-19 *supra* and accompanying text.

45. *See* notes 58-61 *infra* and accompanying text.

46. *See* Comment, *Section 16(b): An Alternative Approach to the Six-Month Limitation Period*, 20 U.C.L.A.L. REV. 1289 (1973).

47. *See* note 12 *supra*.

48. 506 F.2d at 614.

49. *Id.* The court's reasoning may be exemplified by the following two situations: (1) where *X* owns no stock of *ABC* Corporation, but purchases a ten percent interest and within six months of such purchase makes a sale, no liability can attach since "prior to" the purchase *X* was not a beneficial owner; (2) where *X* owns ten percent of *ABC* Corporation, sells to five percent, and within six months of such sale repurchases to over

That *Provident* is correct in holding that a court must look to the time prior to the initiating transaction in determining if a person is an insider is supported by the Supreme Court case of *Kern County Land Company v. Occidental Petroleum Corporation.*[50] There, pursuant to a tender offer made on May 8, 1967, Occidental acquired beneficial ownership status in Kern.[51] On May 11, an extension of Occidental's tender offer resulted in further acquisitions. Within six months of the original tender offer, Occidental executed an agreement with Tenneco, Inc., which had successfully merged with Kern, giving Tenneco an option to purchase Occidental's holdings.[52]

Although concerned primarily with the issue of whether the transactions were a purchase and sale for purposes of section 16(b),[53] the Court did give some indication as to what point in the transaction it is necessary to determine if insider status exists. The Court stated that an initial determination must be made in section 16(b) cases of whether or not there exists the potential for speculative abuse of inside information in the purchase/sale or sale/purchase transactions.[54] In making this

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ten percent, *X* is liable, since "prior to" its sale, and "simultaneously with" its repurchase *X* was a beneficial owner.

50. 411 U.S. 582 (1975).

51. *Id.* at 584.

52. *Id.* at 585-86.

53. The Court decided the case on the basis of the interpretation to be given to "sale and purchase" rather than delving into the interpretation to be given to "at the time of." The Court stated that

> one or more statutory purchases occur when one company, seeking to gain control of another, acquires more than a ten percent interest in the corporation through a tender offer made to its shareholders. But is it a § 16(b) "sale" when the target of the tender offer defends itself by merging into a third company and the tender offeror then exchanges his stock for the stock of the surviving company, also granting an option to purchase the latter stock that is not exercisable within the statutory six-month period?

411 U.S. at 584.

54. The Court in *Kern* determined that section 16(b) was not automatically applicable to all short-swing transactions but only those which presented the potential for speculative abuse of inside information. To this end, the Court stated, a distinction must be made between orthodox and unorthodox transactions. The former are those in which a stock-for-cash or cash-for-stock exchange is made. These transactions require no further analysis but are presumed to involve the potential for speculative abuse. 411 U.S. at 593. Unorthodox transactions consist of "stock conversions, exchanges pursuant to mergers and other corporate reorganizations, stock reclassification, and dealings in options, rights, and warrants." *Id.* at 593 n.24. In these transactions an examination must be made to determine if a potential for speculative abuse actually exists. *Id.* at 595.

The *Kern* Court postulated two factors, both of which must exist in determining if an unorthodox transaction presented the requisite abuse that the statute was designed to prevent. The factors are: (1) whether, at the time the transaction commenced, the "insider" had an opportunity to acquire inside information; and (2) whether the "insider" entered into the transaction voluntarily. 411 U.S. at 596-97, 599-600. Applying determination in regard to Occidental's dealings, the Court noted that prior to its May 11th extension of the tender offer Occidental had ac-

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this criteria to the transaction in *Kern*, the Court concluded that

> the involuntary nature of Occidental's exchange, when coupled with the absence of the possibility of speculative abuse of inside information, convinces us that § 16(b) should not apply to transactions such as this one.

Id. at 600. Other factors a court may wish to consider under this pragmatic approach include: (1) whether the transaction was consummated on a stock exchange; and (2) the benefit that would inure to the individual by the use of inside information. *See* Wentz, *supra* note 25, at 229-30 nn. 23 & 24.

The Court thereby adopted a "pragmatic" approach to section 16(b). Several courts and commentators have stated that such an approach best comports with the achievement of statutory goals. *See, e.g.*, Blau v. Max Factor & Co., 342 F.2d 304 (9th Cir.), *cert. denied*, 382 U.S. 892 (1965); Ferraiolo v. Newman, 259 F.2d 342 (6th Cir. 1958), *cert. denied*, 359 U.S. 927 (1959); Roberts v. Eaton, 212 F.2d 82 (2d Cir.), *cert. denied*, 348 U.S. 827 (1954). *See also* Gadsby & Treadway, *Recent Developments Under Section 16(b) of the Securities Exchange Act of 1934*, 17 N.Y.L.F. 687 (1971); Lowenfels, *Section 16(b): A New Trend in Regulating Insider Trading*, 54 CORNELL L.Q. 45 (1968); Comment, *Stock Exchanges Pursuant to Corporate Consolidation: A Section 16(b) "Purchase or Sale?,"* 119 U. PA. L. REV. 1034 (1969).

The *Provident* court initially concluded that the "threshold test" of *Kern* was inapplicable since the transaction was orthodox. The only distinction between the Provident—Foremost transaction and the usual cash-for-stock sale, the court commented, was the nature of the consideration. 506 F.2d at 601. However, the court's characterization of the transaction is not supported when analyzed in light of SEC rule 16(b)-9, 17 C.F.R. § 240.16(b)-9. This rule provides that where the purchase of a convertible security and the sale of the underlying stock are separated by more than six months, no liability will arise from the transaction. Notwithstanding the time limitation, rule 16(b)-9 evidences that such transactions are to be characterized as non-cash because they may be exempted. The *Provident* court, in finding that the *potentially* convertible debentures bestowed beneficial ownership status on Provident, treated the conversion as exercised. This fictionalized exercise not only subjected the transaction to section 16(b), but also, in view of rule 16(b)-9, provided a non-cash characterization to the transaction, *i.e.*, it was an unorthodox transaction.

Perhaps anticipating that its holding on this question was not particularly strong, the court went on to analyze the transaction as unorthodox under the *Kern* analysis. The court stated that under section 16(b) Congress mandated that any ten percent shareholder be presumed to have access to inside information. Additionally, there was no question that Provident entered into the transaction voluntarily. Therefore the requisites under the *Kern* analysis were met. 506 F.2d at 605.

There is a significant internal inconsistency in the court's analysis on this point. In the subsequent portion of the opinion in which the court discussed the question of whether the initiating transaction could be considered in imposing liability under section 16(b), the court found that Provident was an outsider. This determination led to the conclusions that Provident could not have utilized any inside information acquired by reason of its relationship to Foremost. 506 F.2d at 614. It is questionable whether the court could determine if the *Kern* threshold had been met before a determination of the status of the parties. If an individual is an outsider there is no potential for the speculative abuse of inside information and thus one of the factors considered in *Kern* is lacking. Since the *Provident* court ultimately determined that no potential for speculative abuse existed, then, if the transaction was in fact unorthodox, there was no need for the court to determine if the initiating transaction could give rise to liability under section 16(b).

quired more than ten percent ownership. By examining the extension of the tender as of May 11,[55] as opposed to the date of the original tender offer by which Occidental acquired beneficial ownership, the Court impliedly recognized that one must be a beneficial owner prior to the initiating transaction, *i.e.*, the initial decision to purchase must be based on inside information. Having focused on the May 11th transaction, the Court concluded that section 16(b) was not applicable to Occidental's dealings. Even though Occidental may have been able to conclude, at the time it made its purchase, that it would be able to sell the stock at a profit, these

> [c]alculations . . . [did] 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.[56]

Based on its analysis of *Kern*, the Ninth Circuit stated:

> since a person making a decision to purchase enough stock to increase his holdings to 10 percent of a corporation's outstanding shares could not have made that decision "based on inside information obtained from substantial stockholdings," the Court must have intended for section 16 (b) to apply only after that person becomes a statutory insider.[57]

In view of this analysis, the *Stella* decision, that one who is not an insider prior to the initial transaction may be subject to 16(b) liability, in effect holds that the potential for speculative abuse does not have to exist in the initiating transaction. This is contrary, however, to the language and purpose of the section.

As *Provident* pointed out, Congress intended 16(b) not to be applicable to outsiders. This is evidenced by the fact that the initial draft of section 16(b)[58] provided that profits received by outsiders from short-

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55. 411 U.S. at 598.

56. *Id.* at 597.

57. Provident Sec. Co. v. Foremost-McKesson, Inc., 506 F.2d 601, 609 (9th Cir. 1974), *quoting* Kern County Land Co. v. Occidental Petroleum Corp., 411 U.S. 582, 597 (1973).

58. At one point prior to its passage, section 16(b) read:

> It shall be unlawful for any director, officer, or owner of securities, owning as of record and/or beneficially more than five per centum of any class of stock of any issuer, any security of which is registered on a national securities exchange—
>
> . . . .
>
> (3) To disclose, directly or indirectly, any confidential information regarding or affecting any such registered security not necessary or proper to be disclosed as part of his corporate duties. Any profits made by any person, to whom such unlawful disclosure shall have been made, in respect of any transaction or transactions in such registered security within a period not exceeding six months after such disclosure shall inure to and be recoverable by the issuer unless such person shall have

swing speculation entered into on the basis of confidential information received from insiders could be recovered by the issuer. This provision was deleted from the final draft.[59] Such deletion, without material change in other subsections, evidences congressional intent to exclude outsiders from the applicability of section 16(b).

Judge Hincks, dissenting in *Stella v. Graham-Paige Motors,*[60] emphasized that congressional intent required a rejection of the *Stella* interpretation of "at the time of" because it made the exemption inoperative. He reasoned that, without the exemption, liability could be imposed for any sale so long as one was a beneficial owner at the time of the sale, regardless of his status at the time of the initiating transaction. According to Judge Hincks, the majority's adoption of the district court's interpretation of section 16(b) leading to the imposition of liability in the case, forced the court to commit itself to one of two propositions:

> (a) that any purchase by an outsider of a 10% interest in a stock equity gives rise to a conclusive presumption that the purchaser had inside information as to the affairs of the corporation, or (b) that a sale for profit by a "beneficial owner" of stock in his corporation may give rise to a conclusive presumption of a breach of fiduciary duty even though the seller was under no fiduciary duty at all when he had previously purchased the stock sold.[61]

Both of these propositions were rejected by Judge Hincks. First, they were expressly contrary to the clear and unambiguous language of the statute. Second, the legislative history was clear that such results were not intended. Thus, based on Judge Hincks's analysis, as well as the congressional history surrounding section 16(b), it would appear that the *Provident* court was correct in its holding.

However, the court's conclusion that the section requires one to be a beneficial owner *simultaneously with* the closing transaction appears to be based on the unfounded premise that, for purposes of the section, the transactions must be viewed as separate occurrences. Such a view appears to be contrary to the language of the statute requiring a court to examine the purchase/sale or sale/purchase as one transaction in order

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had no reasonable ground to believe that the disclosure was confidential or was made not in the performance of corporate duties.

Hearings, supra note 22, at 6430.

59. Apparently, the reason for such deletion was the difficulty of proof involved with establishing a violation of section 16(b) on the basis of inside information. *Id.* at 6560-61.

60. 232 F.2d 299, 302 (2d Cir.) (Hincks, J., dissenting), *cert. denied,* 352 U.S. 831 (1956).

61. *Id.* at 303-04.

to determine if the insider dealings could involve a potential for speculative abuse.

Recently, in *Allis-Chalmers Manufacturing Company v. Gulf & Western Industries, Inc.*,[62] the Seventh Circuit stated that such an examination is required for the proper application of the section. There the court agreed with *Provident* that in order for liability to attach one must be a beneficial owner prior to the initial transaction which gives rise to the liability.[63] However, the court rejected *Provident's* bifurcated approach which provided a "simultaneously with" interpretation of "at the time of" as applied to the closing transaction. As the court stated:

> While we agree with much of the analysis in the Ninth Circuit decision in *Provident*, we are convinced that a fundamental conceptual error, initiated in the *Stella* decision, has survived even the careful analysis in *Provident*. It is our view that the legislative history of section 16(b) provides ample support for a construction of that section which obviates any necessity, under any circumstances, to attribute to Congress an intent to utilize a chameleonic definition of the simple phrase "at the time of."[64]

The court based its holding on changes incorporated in the final draft of section 16(b). Originally, the section imposed liability for "any transaction" by an insider within a period of "less than six months."[65] Thus, Congress deemed a purchase/sale transaction to be one single transaction. The purchase/sale and sale/purchase language was included in the revised version to make it clear that a sale/purchase transac-

62. CCH 1975 FED. SEC. L. REP. ¶ 95,308 (7th Cir. Sept. 29, 1975). In *Allis-Chalmers*, Gulf & Western sought an acquisition of Allis-Chalmers. An exchange offer was made by Gulf & Western, by which it acquired more than ten percent of Allis' outstanding stock. Shortly thereafter, Gulf & Western purchased an additional amount of shares, giving as consideration some of its own warrants. Within six months, Gulf & Western sold all of its Allis holdings at a substantial profit. Allis sought to recover these profits, alleging they were the result of the use of inside information. Gulf & Western responded that at the time it made its initial acquisition it was not a beneficial owner, and thus outside section 16(b). Although the court found Gulf & Western to be outside the scope of the statute in regard to its first purchase, it did assess liability for the profit realized on the second acquisition.

63. *Id.* at 98,554.

64. *Id.* at 98,553.

65. The early draft provided:

> (b) It shall be unlawful for any [beneficial owner]
>
> (1) To purchase any such registered security with the intention or expectation of selling the same security within six months; and any profit made by such person *on any transaction in such a registered security extending over a period of less than six months* shall inure to and be recoverable by the issuer, irrespective of any intention or expectation on his part in entering into such *transaction* of holding the security purchased for a period exceeding six months.

Quoted in *id.* at 95,553-54.

tion would fall within the section. The court concluded that the differences between the initial draft of 16(b) and the finalized version of the section indicate that Congress intended the entire transaction to be examined to determine if there existed a potential for speculative abuse. Section 16(b) does not require and was never intended to require a court to examine the series of transactions separately.[66]

Thus, it was unnecessary to have an independent examination of the "insider's intention 'in entering into such transaction,' [and] would indicate that Congress still meant to focus on insider status 'prior to' the unitary transaction in question and not 'simultaneously with' the initial step in that transaction, as suggested in *Stella* and later cases."[67]

CONCLUSION

To prevent unfair abuse of inside information, section 16(b) provides that any profits realized by a party from a transaction within a six month period shall be paid to the issuer regardless of any intention to make use of such information. Because the presumption created by the statute is conclusive, courts have applied this section with an aim toward avoiding "purposeless harshness."[68]

Although the courts agree that section 16(b) should be read in order to best effectuate congressional intent, a split among the circuit courts has developed as to how the section should be applied in order to effectuate that purpose. A key divergence in opinion has evolved concerning when the section becomes operative. In the Ninth Circuit, at least, the section is to be read as creating dual-transactions. Insofar as the initial transaction is concerned, the section is not applicable unless a party is a beneficial owner prior to the time of that transaction. This accords with congressional intent that the statute is operative only because of one's relationship to the issuer. Since Provident, prior to its consummation of the Foremost exchange, had no relationship with the latter, it was deemed to be an outsider, and thus outside the provisions of the section. However, the *Provident* court erroneously held that such person must be a beneficial owner "simultaneously with" the closing transaction. Because such an analysis requires the court to make a sepa-

66. *Id.* at 98,554.
67. *Id.*
68. Blau v. Lamb, 363 F.2d 507, 519 (2d Cir. 1966), *cert. denied*, 385 U.S. 1002 (1967). *See* Blau v. Max Factor & Co., 342 F.2d 304 (9th Cir.), *cert. denied*, 382 U.S. 892 (1965).

rate determination as to the status of the party at the time of the closing transaction, the *Provident* court interpreted the statute contrary to the express language of the section.

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