Exceptions to Liability under Section 16(b): A Systematic Approach
Exceptions to Liability under Section 16(b): A Systematic Approach

Section 16(b) of the Securities Exchange Act of 1934 is a paradigmatic strict liability statute. To deter corporate insiders from engaging in short-swing speculations in their corporation's stock on the basis of information not available to the public, and to avoid difficulties in

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

On the definition of "beneficial owner" in § 16(a), see note 5 infra.

2. Accord, Stock Exchange Practices: Hearings on S. Res. 81, S. Res. 56 and S. Res. 97 Before the Senate Comm. on Banking and Currency, 73d Cong., 2d Sess., pt. 15, at 6558 (1934), reprinted in 6 LEGISLATIVE HISTORY OF THE SECURITIES ACT OF 1933 AND SECURITIES EXCHANGE ACT OF 1934 (J. Ellenberger & E. Mahar comps. 1973) (Item 22) (Thomas G. Corcoran, principal draftsman) ("You have to have a general rule. In particular transactions it might work a hardship, but those transactions that are a hardship represent the sacrifice to the necessity of having a general rule.") [hereinafter cited as Hearings on Stock Exchange Practices] [compilation hereinafter cited as LEGISLATIVE HISTORY]; id. at 6557 (Thomas G. Corcoran referring to § 16(b) as "crude rule of thumb"), quoted in note 4 infra.

3. As stated in its preamble, the purpose of § 16(b) is to prevent "the unfair use of information which may have been obtained by [a statutory insider] by reason of his relationship to the issuer." 15 U.S.C. § 78p(b) (1970). See, e.g., S. Rep. No. 792, 73d Cong., 2d Sess. 9, 21 (1934), reprinted in 5 LEGISLATIVE HISTORY, supra note 2 (Item 17); S. Rep. No. 1455, 73d Cong., 2d Sess. 55 (1934), reprinted in 5 LEGISLATIVE HISTORY, supra note 2 (Item 21).

Congress enacted § 16(b) to curtail the prevalent abuse, revealed in congressional investigations, of fiduciary relationships by corporate insiders. These abuses included excessive use of margin transactions, see Stock Exchange Regulation: Hearing on H.R. 7852 and H.R. 8720 Before the House Comm. on Interstate and Foreign Commerce, 73d Cong., 2d Sess. 85 (1934), reprinted in 8 LEGISLATIVE HISTORY, supra note 2 (Item 23) [hereinafter cited as Hearing on H.R. 7852], stock pooling, see S. Rep. No. 1455, supra at 32-33, trading on advance information, see S. Rep. No. 792, supra at 9, and other market manipulations, see S. Rep. No. 1455, supra at 55-68; H.R. Rep. No. 1383, 73d Cong., 2d Sess. 13-14 (1934),
Exceptions to Section 16(b) Liability

proving intent to speculate. Congress imposed liability under section 16(b) solely on the basis of insider status. Thus any officer, director, or "beneficial owner" is liable to the corporation for any profits realized.

reprinted in 5 LEGISLATIVE HISTORY, supra note 2 (Item 18). See generally Hearing on H.R. 7332, supra at 6483-6581. Prior to 1934, windfall profits from "sure thing" speculation were generally accepted by the financial community as one of the usual emoluments of office. SECURITIES AND EXCHANGE COMMISSION, TENTH ANNUAL REPORT, H.R. Doc. No. 158, 79th Cong., 1st Sess. 50 (1944); Cook & Feldman, Insider Trading under the Securities Exchange Act (pl. 1), 66 HARV. L. REV. 385, 386 (1953).

4. See, e.g., Hearings on Stock Exchange Practices, supra note 2, at 6556-57:

Mr. CORCORAN [principal draftsman] . . . You hold the director, irrespective of any intention or expectation to sell the security within 6 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.

Senator GORE. You infer the intent from the fact.

Mr. CORCORAN. From the fact.

Senator KEAN. Suppose he got stuck in something else, and he had to sell?

Senator BARKLEY. All he would get would be what he put into it. He would get his original investment.

Mr. CORCORAN. He would get his money out, but the profit goes to the corporation.

Senator KEAN. Suppose he had to sell.

Mr. CORCORAN. Let him get out what he put in, but give the corporation the profit.

5. A statutory insider is defined in § 16(a) of the Act to be a person who is "directly or indirectly the beneficial owner of more than 10 per centum of any class of any [registered, nonexempt] equity security . . . or who is a director or an officer of the issuer of such security." 15 U.S.C. § 78p(a) (1970). As used here, the term beneficial owner is synonymous with 10% stockholder. Cf. Note, "Beneficial Ownership" Under Section 16(b) of the Securities Exchange Act of 1934, 77 COLUM. L. REV. 446 (1977) (discussing scope of "beneficial ownership" beyond mere legal ownership; arguing that "beneficial ownership" should be narrowly construed). The definition of "officer" includes "a president, vice-president, treasurer, secretary[,] comptroller, and any person who performs for an issuer, whether incorporated or unincorporated, functions corresponding to those performed by the foregoing officers." 17 C.F.R. § 240.3b-2 (1977). Merely holding the title of an officer does not necessarily subject one to § 16(b) liability. Colby v. Klune, 178 F.2d 872, 873 (2d Cir. 1949); Schimmel v. Goldman, 57 F.R.D. 481, 485-87 (S.D.N.Y. 1973) (noting potential issue for trial in approving stipulation of settlement). In the absence of explicit deputization, a director will be liable for any profits realized by him, but not for profits gained by the partnership of which he is a member. Blau v. Lehman, 368 U.S. 403, 414 (1962). A partnership or corporation may be held liable as a director, however, where there is proof of deputization. Feder v. Martin Marietta Corp., 406 F.2d 260, 263 (2d Cir. 1969), cert. denied, 396 U.S. 1036 (1970).

6. In an action under § 16(b), the corporation will ordinarily be the plaintiff, but, in the event that the corporation fails to bring suit, or refuses to do so following a proper demand on it, any security holder may maintain an action under § 16(b) on behalf of the corporation. 15 U.S.C. § 78p(b) (1970). In contrast to the plaintiff in an ordinary stockholder's derivative action, see, e.g., Capitol Wine & Spirit Corp. v. Pokras, 277 App. Div. 184, 98 N.Y.S.2d 291 (1950), aff'd, 302 N.Y. 734, 98 N.E.2d 704 (1951); Fed. R. Civ. P. 23.1, the § 16(b) plaintiff need not have been a stockholder at the time of the challenged purchase and sale transactions. 2 L. Loss, SECURITIES REGULATION 1046 (2d ed. 1961).

7. Smolowe v. Delendo Corp., 136 F.2d 231 (2d Cir.), cert. denied, 320 U.S. 751 (1943), first established the "lowest price in, highest price out" method of computing the short-swing profits subject to § 16(b). Id. at 239. Liability is calculated by subtracting the lowest purchase price from the highest sale price within six months, the next lowest purchase from the next highest sale, and so on. The sum of these differences is then the amount of recovery. Thus an insider who has completed a series of transactions within a
on a purchase and sale, or sale and purchase, of the corporation's equity securities within any six-month period.

The history of actions under section 16(b), however, evinces a persistent judicial uneasiness with the categorical liabilities imposed by the statute. Courts have repeatedly fashioned ad hoc exemptions from the statute in circumstances appearing to afford little opportunity for the speculative abuse of inside information that Congress sought to prevent. This in itself may not be objectionable, for courts have always refused to enforce statutes according to their literal terms when doing so would not “suppress the mischief, and advance the remedy, ... according to the true intent of the makers of the Act.” But the explicit congressional intent to impose clear and certain liability within narrowly drawn limits requires that exemptions from the operation of the six-month period could be liable under § 16(b) for “profits realized” even though he sustained a net loss in his transactions. 2 L. Loss, supra note 6, at 1063-64 & n.118 (discussing case where defendant sustained $400,000 net loss on transactions but still suffered $300,000 judgment). This punitive aspect of the formula has been criticized. Munter, Section 16(b) of the Securities Exchange Act of 1934: An Alternative to “Burning Down the Barn in Order to Kill the Rats,” 52 CORNELL L.Q. 69, 81-85 (1966); Painter, The Evolving Role of Section 16(b), 62 Mich. L. Rev. 649, 652-57 (1964).

8. “Equity security” is defined in 15 U.S.C. § 78c(a)(11) (1970). Compare Chemical Fund, Inc. v. Xerox Corp., 377 F.2d 107, 110 (2d Cir. 1967) (company holding more than 10% of corporation's convertible debentures, which if converted would amount only to 2.72% of corporation's common stock, not “beneficial owner of more than 10% of any class of any equity security”) with Foremost-McKesson, Inc. v. Provident Sec. Co., 423 U.S. 232, 236 & n.5 (1976) (owner of debentures convertible into more than 10% of corporation's common stock is beneficial owner).


10. See pp. 1436-41 infra.

11. Heydon's Case, 76 Eng. Rep. 637, 638 (1584); accord, United Hous. Foundation, Inc. v. Forman, 421 U.S. 837, 848-49 (1975); Church of the Holy Trinity v. United States, 143 U.S. 457 (1892). Moreover, the decision by the Supreme Court in Forman provides specific authority for the flexible interpretation of explicit language in the securities laws in order to effect the legislative intent. 421 U.S. at 848-49. In light of the underlying economic realities of the transaction involved, the Forman Court rejected “any suggestion that the present transaction, evidenced by the sale of shares called 'stock,' must be considered a security transaction simply because the statutory definition of a security includes the words 'any . . . stock,'” id. at 848 (footnote omitted), and refused to hold the certificates at issue stock within the meaning of the Securities Act, id.

12. The legislative history indicates that § 16(b) was to serve only a limited purpose, largely subordinate to the disclosure features of § 16(a), 15 U.S.C. § 78p(a) (1970). Section 16(a) has as its purpose the exposure of insider trading to “the white glare of publicity.” Cook & Feldman, supra note 3, at 405. A congressional report, in referring to an earlier draft of § 16(a), considered that provision “the most potent weapon against the abuse of
section 16(b) be both minimal and well-defined.\textsuperscript{13}

Section 16(b) offers two choices for restricting the extent of its liabilities. A court may limit the broad statutory definitions of purchase and sale,\textsuperscript{14} or it may constrict the definitions of insider status.\textsuperscript{15} In general, courts have adopted the first alternative.\textsuperscript{16} This approach, epitomized by the Supreme Court's decision in \textit{Kern County Land Co. v. Occidental Petroleum Corp.},\textsuperscript{17} focuses on the potential for speculative abuse inherent in the transaction itself to determine whether the transaction in question is a statutory "purchase" or "sale."\textsuperscript{18}
This Note argues that the courts should have chosen the second alternative—that of limiting the scope of insider status—as the more accurate and certain means of determining whether the absence of potential for speculative abuse justifies exemption from section 16(b) liability. Part I analyzes Kern and related cases and demonstrates that their transactional analysis fails to provide a reliable test: one cannot accurately isolate potential for speculative abuse of inside information on the basis of the form of the transaction alone. Further, Part II argues that, though these cases focused on particular transactions, courts have usually been most concerned about the control exercised by the insider and have feared, as had Congress, the ability of the insider to pervert his control of the issuer to private ends. Part III therefore proposes a more systematic and reliable way to bring congressional intent and judicial interpretation into harmony. The courts should allow the noncontrolling beneficial owner to prove lack of control and lack of access to inside information as an affirmative defense to section 16(b) liability.

I. Kern and the Transactional Approach

Even in early cases courts were concerned that literal interpretation and mechanical application of section 16(b) would extend liability to many situations lacking any potential for short-swing speculation by corporate insiders. To avert this possibility, they developed exceptions to section 16(b) liability based on the form of the transactions involved.

A. Kern County Land Co. v. Occidental Petroleum Corp.

Although lower courts had previously cut back on section 16(b) liability by exempting certain "unorthodox" transactions, Kern was the first Supreme Court decision to exclude a transaction from the statutory definitions of purchase and sale on the explicit ground that

19. See, e.g., Roberts v. Eaton, 212 F.2d 82, 83, 85-86 (2d Cir.), cert. denied, 348 U.S. 827 (1954) (reclassification held not a purchase because it "could not possibly lend itself to the speculation encompassed by § 16(b)"); Shaw v. Dreyfus, 172 F.2d 140, 142 (2d Cir.), cert. denied, 337 U.S. 907 (1949) (exempting "bona fide" gifts as not "within the evil at which the statute was aimed").

20. The term, coined by Professor Loss, includes exchanges pursuant to mergers and other corporate reorganizations, stock reclassifications, and dealings in options, rights, and warrants; it has been incorporated as a technical term into the vocabulary of § 16(b). See Kern County Land Co. v. Occidental Petroleum Corp., 411 U.S. 582, 593 & n.24 (1973) (citing 2 L. Loss, supra note 6, at 1069). See generally id. at 1066-82; p. 1449 & notes 56-60 infra. For discussion of the problems in determining the orthodoxy of a transaction, see pp. 1438-41 infra.
the transactions involved did not afford potential for speculative abuse of inside information. 21 The case arose in the context of a tender offer defeated by the merger of the target company into a third company. 22 The imminent merger raised the possibility of section 16(b) liability for the tender offeror, Occidental, which would be forced to exchange its shares in the target company, Kern, for shares in the surviving corporation. To avoid possible section 16(b) liability, Occidental granted to the third company, Tenneco Corp., a call option on its shares in the surviving corporation. 23 The option was not exercisable within the six-month statutory period. The question, as presented to the Court, was whether either of these transactions—the exchange pursuant to the merger or the granting of the call option—constituted a sale within the meaning of section 16(b). 24 Under a literal reading of the statute, the liability of Occidental, an acknowledged insider, 25 would have been certain. 26 The Court nevertheless held that the transactions involved were not within the ambit of the statute. 27

The Kern majority inquired "whether the transaction may serve as a vehicle for the evil which Congress sought to prevent—the realization of short-swing profits based upon access to inside information." 28 The opportunity to reap such speculative gain, the Court emphasized, must

21. Including Kern, the Supreme Court has decided four cases dealing with § 16(b). See note 15 supra (citing cases).

22. On May 8, 1967, after an unsuccessful attempt to merge with Kern County Land Co., Occidental Petroleum Corp. announced an offer to buy 500,000 shares of Kern common stock; within two days, the shares, which represented more than 10% of all outstanding Kern stock, had been tendered, and on May 11 Occidental extended the terms of its tender offer to include an additional 500,000 shares. 411 U.S. at 584-85. Kern’s management advised its shareholders not to tender and subsequently negotiated a defensive merger between Kern and a newly created subsidiary of Tenneco, Inc. (New Kern). The merger agreement provided that each share of Kern common stock be exchanged for one share of a new Tenneco convertible preferred stock. Id. at 585-86. Faced with the prospect of being locked into a minority position, Occidental sought to extricate itself by executing an option agreement with Tenneco on June 2. Under the agreement, Tenneco Corp., a wholly owned subsidiary of Tenneco, Inc., would be entitled to purchase Occidental’s shares of Tenneco preferred. In an attempt to avoid liability under § 16(b), Occidental stipulated that the option could not be exercised within the six months following the expiration of Occidental’s offer. Id. at 587-88. Occidental’s old Kern stock was automatically converted into claims for Tenneco preferred at the closing of the merger on August 30, but the actual exchange of shares did not occur until December 11, when Tenneco Corp. exercised the option. Id. at 589. Kern sued Occidental under § 16(b) to recover profits Occidental had realized by trading in old Kern stock. Id. at 590.

23. Occidental’s alternatives were to accept a minority position in the surviving corporation, an unappealing course of action, or to sell the shares for cash, which would result in certain § 16(b) liability. See 411 U.S. at 600.

24. Id. at 584.

25. Id. at 595 (recognizing Occidental’s status as beneficial owner under § 16(b)).

26. See id. at 600.

27. Id. at 600, 604 (two transactions).

28. Id. at 594 & n.26 (citing “[b]y far the greater weight of authority”); id. at 596 (adopting test).
derive from access to corporate inside information; Occidental's knowledge that even if its takeover attempts failed it might be able to sell its stock at a substantial profit was immaterial. Finding nothing to indicate either the possibility of inside information being available to Occidental or the potential for its speculative abuse, the Court concluded that neither transaction was a sale giving rise to section 16(b) liability. The Court stressed the involuntary nature of the transactions as a critical factor in its decision.

The Kern opinion, however, leaves many ambiguities in the application of section 16(b). The Court did not specify which findings—lack of access to inside information, absence of any possibility for its speculative abuse, and involuntary nature of the transactions—are necessary, and which sufficient, to yield the conclusion that a given transaction lies outside the purview of section 16(b). Certainly lack of access to inside information would preclude potential for its abuse, but whether the Court considered the lack of access and the involuntary nature of the transactions as additional requirements to the absence of potential for speculative abuse remains unclear.

The ambiguities of Kern have engendered considerable confusion among lower courts attempting to apply its doctrine to other unorthodox transactions. Although the Kern Court apparently would not have required proof of actual access to inside information, the Fourth Circuit has since held that actual knowledge of inside informa-

29. Id. at 597.
30. Id. at 599-600, 604.
31. Id. at 599-600.
33. Compare 411 U.S. at 594 (test is whether transaction may serve as vehicle for realization of short-swing profits based on access to inside information); id. at 599 ("There is . . . nothing . . . to indicate either the possibility of inside information being available to Occidental by virtue of its stock ownership or the potential for speculative abuse of such inside information by Occidental.") and id. at 600 ("But 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.") with id. at 602 ("The option . . . does not appear to have been an instrument with potential for speculative abuse, whether or not Occidental possessed inside information about the affairs of Old Kern.")
34. See pp. 1437-39 infra.
36. See 411 U.S. at 596 (finding "it totally unrealistic to assume or infer from the facts . . . that Occidental either had or was likely to have access to inside information" (emphasis added)).

1436
Exceptions to Section 16(b) Liability

...tion is a prerequisite to section 16(b) liability. And Kern's ambiguity concerning which factors among access to inside information, control over the transactions, and potential for speculative abuse are necessary prerequisites to section 16(b) liability has permeated lower court opinions. Moreover, the transactional analysis adopted by Kern leads to the anomalous result reached in Gold v. Sloan, in which the court treated the same transaction as a statutory purchase by some defendants but not by others.

The Supreme Court has yet to clarify the meaning of Kern. In Foremost-McKesson, Inc. v. Provident Securities Co., its only post-Kern foray into section 16(b), the Court decided only a narrow question of insider status and thus never reached the purchase/sale...
But by inquiring into the potential for speculative abuse inherent in particular transactions, Kern and related cases have both considerably limited the extent of liability under section 16(b) and radically altered the operation of the statute itself.

B. The Failure of Transactional Analysis

The courts have not been unaware of the effects of their attack on section 16(b). Indeed, in an effort to circumscribe judicial abrogation of section 16(b), they have attempted to restrict inquiries into potential for speculative abuse of inside information to a narrow class of unorthodox transactions. But adequate criteria for determining the orthodoxy of a given transaction have yet to be articulated, probably because the form of a transaction does not necessarily determine the potential for speculative abuse. The cases thus have an ad hoc quality—an undesirable result given the intent of Congress to impose clear and certain liability under section 16(b).


Although Foremost-McKesson explicitly reserved the question whether beneficial ownership would be required prior to the purchase in a sale-and-repurchase sequence, 423 U.S. at 242 & n.15, the Court adduced "[a]dditional considerations," id. at 251-60, that suggest, albeit in dictum, that a beneficial interest will be required prior to both transactions in any short-swing sequence. See id. at 241 n.12, 255 n.29 (suggesting that Rule 10b-5 would provide remedy for abuses not covered under such construction of exemptive provision). But see id. at 255 (existence of alternative remedies irrelevant to liability under § 16(b)); cf. note 93 infra (discussing inadequacies of Rule 10b-5 remedy).

44. 423 U.S. at 239 n.8 (holding precluded consideration of issue raised in Kern—whether transaction was within ambit of § 16(b)).


46. See note 12 supra.

47. For a discussion of the problems of defining unorthodox transactions, see, e.g., Note, supra note 32, at 685-88; Note, supra note 35, at 623-25.
real issue. The suggestion in Kern, for example, that unorthodox transactions are those “not ordinarily deemed a sale or purchase”\(^\text{48}\) avails little, except to permit subsequent inquiry into potential for abuse, and provides little guidance on when such inquiry is appropriate.\(^\text{49}\) The same is true of the Ninth Circuit’s attempt to define orthodox as “cash-for-stock or essentially cash-for-stock.”\(^\text{50}\) Since the court found “no meaningful distinction between consideration in the form of cash and consideration in the form of a corporate asset,”\(^\text{51}\) the test simply substitutes one verbal formula for another. Moreover, this formulation would reach many transactions, such as conversions and exchanges of shares pursuant to mergers, previously considered unorthodox.\(^\text{52}\)

The only suggested test that goes beyond semantic manipulation is one that considers whether the transaction was in some sense “involuntary,”\(^\text{53}\) but the courts have disagreed on whether involuntariness is a necessary requirement to a finding of lack of potential for speculative abuse.\(^\text{54}\) Yet even if an insider has no control over a given transaction, knowledge of its imminent occurrence might nonetheless enable him to abuse inside information by coupling a second transaction with the involuntary one.\(^\text{55}\)

This judicial struggle with the orthodoxy of transactions suggests that attempts to limit liability under section 16(b) by using the statutory definitions of purchase and sale are unlikely to succeed. Indeed,

---

48. 411 U.S. at 593-94.
49. See id. at 594-95 & n.26.
52. See pp. 1440-41 infra (discussing development of exemptions for unorthodox transactions).
54. See note 38 supra.
55. Cf. Heli-Coil Corp. v. Webster, 352 F.2d 156, 165 (3d Cir. 1965) (en banc) (plurality opinion of Biggs, C.J.) (although transaction voluntary, court concerned about possible speculation based on advance knowledge of transaction). That § 16(b) does not reach speculative calculations prior to attainment of insider status, Foremost-McKesson, Inc. v. Provident Sec. Co., 423 U.S. 232, 241 n.13, 244 & n.20 (1976); Kern County Land Co. v. Occidental Petroleum Corp., 411 U.S. 582, 597 (1973); see p. 1436 supra, is not to the contrary. In Kern, for example, Occidental had no access to inside information and thus could not have abused such information in executing its agreement with Tenneco. See note 22 supra.
because different defendants may have different opportunities to acquire and abuse inside information, one would suspect that transaction-focused inquiries are likely to produce inconsistent and unpredictable results. The history of the transactional approach, moreover, largely confirms this suspicion. Gifts were the first transactions held not to be purchases or sales under section 16(b);\textsuperscript{56} certain reclassifications,\textsuperscript{57} conversions,\textsuperscript{58} options,\textsuperscript{59} and exchanges between corporations\textsuperscript{60} followed. Since they by definition involve no consideration,\textsuperscript{61} gifts afforded no opportunity for profit\textsuperscript{62} nor, at first glance, did later cases involving the conversion of "economically equivalent" shares of a single issuer.\textsuperscript{63} But "economic equivalence" proved insufficient to preclude

\textsuperscript{57} See Roberts v. Eaton, 212 F.2d 82 (2d Cir.) cert. denied, 348 U.S. 827 (1944).
\textsuperscript{59} See Kern County Land Co. v. Occidental Petroleum Corp., 411 U.S. 582, 601-04 (1973). Although "the mere execution of an option to sell is not generally regarded as a 'sale,'" id. at 601, the courts have struggled with the question of when an option, of course involves a right to a transfer of stock, becomes a purchase or sale. See id. at 601-04 (grant of call option not affording opportunity for speculative abuse not a sale); Bershad v. McDonough, 428 F.2d 693, 698 (7th Cir. 1970), cert. denied, 400 U.S. 992 (1971) (grant of option including irrevocable proxy to vote underlying shares sold held sale); Booth v. Varian Assoc's., 334 F.2d 1, 5 (1st Cir.), cert. denied, 379 U.S. 961 (1964) (purchase occurred on date of exercise of option because only then did price of stock become fixed and did defendants have opportunity for speculation); Blau v. Oggsby, 210 F.2d 426, 427 (2d Cir. 1954) (exonerating defendant; purchase consummated at time option was acquired, i.e., when defendant became irrevocably bound to take and pay for stock, rather than at time option was exercised, i.e., not when payment actually was made). See generally Note, Put and Call Options Under Section 16 of the Securities Exchange Act, 69 Yale L.J. 868 (1960).
\textsuperscript{60} See Kern County Land Co. v. Occidental Petroleum Corp., 411 U.S. 582 (1973); American Standard, Inc. v. Crane Co., 510 F.2d 1043 (2d Cir. 1974), cert. denied, 421 U.S. 1000 (1975); Blau v. Mission Corp., 212 F.2d 77, 80 (2d Cir.), cert. denied, 347 U.S. 1016 (1954) (no liability where transaction was "mere transfer between corporate pockets" of parent and wholly owned subsidiary).
\textsuperscript{62} Shaw v. Dreyfus, 172 F.2d 140, 143 (2d Cir.), cert. denied, 337 U.S. 907 (1949) ("It is plain that [defendant] realized no profit by making the gifts."); Lewis v. Adler, 331 F. Supp. 1258, 1259 (S.D.N.Y. 1971) (bona fide gift exempt); Truncale v. Blumberg, 80 F. Supp. 387, 389 (S.D.N.Y. 1948) ("[T]he courts have struggled with the question of when an option, of course involves a right to a transfer of stock, becomes a purchase or sale. See id. at 601-04 (grant of call option not affording opportunity for speculative abuse not a sale); Bershad v. McDonough, 428 F.2d 693, 698 (7th Cir. 1970), cert. denied, 400 U.S. 992 (1971) (grant of option including irrevocable proxy to vote underlying shares sold held sale); Booth v. Varian Assoc's., 334 F.2d 1, 5 (1st Cir.), cert. denied, 379 U.S. 961 (1964) (purchase occurred on date of exercise of option because only then did price of stock become fixed and did defendants have opportunity for speculation); Blau v. Oggsby, 210 F.2d 426, 427 (2d Cir. 1954) (exonerating defendant; purchase consummated at time option was acquired, i.e., when defendant became irrevocably bound to take and pay for stock, rather than at time option was exercised, i.e., not when payment actually was made). See generally Note, Put and Call Options Under Section 16 of the Securities Exchange Act, 69 Yale L.J. 868 (1960).
Exceptions to Section 16(b) Liability

potential for speculative abuse, and the courts split hopelessly on what additional factors were necessary. The SEC eventually resolved this confusion by rule, thereby relieving courts of much of the interpretive burden that had developed, but much of this confusion survives in contemporary cases dealing with mergers and other transfers of corporate control, where the exchange of shares takes place not in a single issuer but between distinct corporations.

As these cases illustrate, the transactional approach developed on an ad hoc basis in response to particular transactions that did not seem to afford potential for speculative abuse. Although the common concern has clearly been the potential for speculative abuse of inside information, each transaction has developed its own standards for exclusion, and the rules established for one set of transactions have often proved inappropriate to another. As a result, the law of purchase and sale under section 16(b) has become subject to all the vagaries and inconsistencies of an inchoate common law.

II. Insider Control and Access to Inside Information

Although the transaction-tied exemptions to section 16(b) liability developed on a case-by-case basis, one recurrent consideration runs through Kern, its predecessors, and its progeny—the ability of the insider to use his position of control in the issuer to reap speculative gains. Problems of consistency have arisen primarily because control and access to inside information—issues of insider status—have been inappropriately incorporated into the statutory definitions of purchase and sale.

Originally, the control of the insider was regarded as important principally because it enabled him to profit through manipulations of opinion of Biggs, C.J.) (holding conversion to be sale but incorporating value of redemption privilege in computation of profits realized); id. at 171 (McLaughlin, J., concurring on point).

64. See 5 L. Loss, supra note 6, at 3029-40 (2d ed. Supp. 1969) (detailed discussion of "generalization-defying nature" of conversion cases).
66. See Kern County Land Co. v. Occidental Petroleum Corp., 411 U.S. 582, 612 (1973) (Douglas, J., dissenting) ("[B]y sanctioning the approach of these [conversion] cases, the majority brings to fruition Louis Loss' prophecy that they will 'continue to rule us from their graves,' for henceforth they certainly will be applied by analogy to the area of mergers and other consolidations." (footnote omitted)); American Standard, Inc. v. Crane Co., 510 F.2d 1043, 1058-63 (2d Cir. 1974), cert. denied, 421 U.S. 1000 (1975); Newmark v. RKO Gen., Inc., 425 F.2d 348, 354 (2d Cir.), cert. denied, 400 U.S. 854 (1970) (test of economic equivalence inapplicable to exchange of shares between two different issuers); pp. 1436-37 & note 40 supra.
the affairs of the issuer. In the early gift cases, for example, liability was not imposed on the officers and directors involved, despite the considerable control they exercised in their corporations, because their gifts opened no avenues for profit based on that control. Control also proved important in conversion cases. Although broad language in the early case of *Park & Tilford, Inc. v. Schulte* appeared to encompass all conversions, many courts distinguished the case by noting that the *Park & Tilford* defendants had abused their complete control of the corporation to profit from their conversions. Thus, the court of appeals in *Foremost-McKesson* held that the insider's control of the transactions involved was sufficient to support a finding of potential for abuse.

In addition to examining the insider's control over the affairs of his corporation, however, courts have occasionally inquired whether the control of the insider in fact afforded him access to inside information. The most recent examples of such inquiry appear in contemporary cases involving mergers and other transfers of corporate control. The *Kern* Court, for example, supported its finding that the transactions at issue afforded no potential for speculative abuse by noting that a ten-percent shareholder does not necessarily exercise sufficient control over the issuer to gain access to inside information. As noted previously, *Kern* does not make clear the degree of separability between access and control in analyzing potential for abuse. Nevertheless, the *Kern* Court clearly considered Occidental's lack of control over the merger to be

67. Cf. 15 U.S.C. § 78p(b) (1970) (first sentence) (purpose of statute to "[prevent] the unfair use of information which may have been obtained by [a statutory insider] by reason of his relationship to the issuer").
68. See p. 1440 *supra*.
69. 160 F.2d 984, 987 (2d Cir.), cert. denied, 332 U.S. 761 (1947) ("We think a conversion of preferred into common stock followed by a sale within six months is a 'purchase and sale' within the statutory language of § 16(b). . . . Defendants did not own the common stock in question before they exercised their option to convert; they did afterward.")
73. See p. 1436 & note 33 *supra*.
Exceptions to Section 16(b) Liability

"critical" in exonerating Occidental. Indeed, Kern was the first case to permit inquiry into access to inside information.

III. A Proposal

In their concern with potential for speculative abuse of inside information and their concomitant attention to issues of access and insider control, the courts have isolated the proper criteria to guide interpretation of section 16(b) "according to the true intent of its makers." In dealing with insiders, Congress's primary concern was to protect the ordinary shareholder from those with information not available to him, and the cases to date seem consistent with that purpose. For example, liability under section 16(b) has not been imposed when it would provide a windfall recovery to a controlling shareholder at the expense of a noncontrolling shareholder with no access to inside information and whose relation to the issuer was no different from that of an ordinary shareholder.

74. 411 U.S. at 599.
75. See id. at 599-600.
76. See Note, supra note 32, at 683. For typical pre-Kern discussions of access, see Reliance Elec. Co. v. Emerson Elec. Co., 404 U.S. 418, 431 (1972) (Douglas, J., dissenting on other grounds) ("Profits are forfeit without proof of an insider's intent to gain from inside information, and without proof that the insider was even privy to such information," (footnote omitted)); Feder v. Martin Marietta Corp., 406 F.2d 260, 262 (2d Cir. 1969), cert. denied, 396 U.S. 1036 (1970) ("[A]pplication of the act is not conditional upon proof of an insider's intent to profit from unfair use of information . . . or upon proof that the insider was privy to any confidential information . . . ." (citations omitted)). In Ferraiolo v. Newman, 259 F.2d 342 (6th Cir. 1958), cert. denied, 359 U.S. 927 (1959), however, although the court held access "entirely irrelevant to the applicability of Section 16(b)," id. at 344, it may have subsumed considerations of access under another heading. See id. at 346 (whether transaction had "economic indicia" of purchase rests in part on full disclosure).
77. See Hearing on H.R. 7852, supra note 3, at 85 (Thomas G. Corcoran).

Liability under § 16(b) would make tender offer target companies more attractive merger partners for third companies. Abrams v. Occidental Petroleum Corp., 450 F.2d 157, 163-64 (2d Cir. 1971), aff'd sub nom. Kern County Land Co. v. Occidental Petroleum Corp., 411 U.S. 582 (1973). If a merger were completed within six months of the initial offer, the third company would be able to sue the tender offeror under § 16(b) and recover the difference between the cost of his shares in the target company and the tender price. See, e.g., 84 Harv. L. Rev. 1012, 1021-22 (1971). Such a recovery by the successor corporation would not only disrupt the economic competition upon which the Securities Exchange Act depends for its protection of the individual investor but would also benefit a controlling shareholder—the third company—at the expense of the tender offeror, who may or may not be a controlling insider. American Standard, Inc. v. Crane Co., 510 F.2d 1043, 1061 & n.34 (2d Cir. 1974), cert. denied, 421 U.S. 1000 (1975); Abrams v. Occidental Petroleum Corp., 450 F.2d 157, 163-64 and nn.12 & 14 (2d Cir.
The problem with section 16(b) interpretation, then, is not that the courts have concluded incorrectly that potential for speculative abuse constitutes the crucial factor in formulating exceptions and that the indicia of such potential are access to inside information and control by the insider. Such conclusions seem quite correct. Rather, the problem is that the courts have injected an unreliable factor—the form of the transaction—into what should be a straightforward inquiry into the relevant variables. Instead of distinguishing between orthodox and unorthodox transactions, or inquiring whether the transaction constitutes a purchase or sale, the courts should distinguish among insiders on the basis of access and control in determining whether an exception to section 16(b) liability is justified. Properly formulated, a test based on insider status furnishes a more accurate measure of potential for speculative abuse than the form of the transaction; it also more closely reflects the original congressional intent. Thus, regardless of the type of the transaction involved, courts should hold officers, directors, and controlling beneficial owners strictly liable irrespective of their ability to prove lack of opportunity for speculative abuse, but they should exonerate the noncontrolling beneficial owner able to prove lack of access to inside information.

Strict liability for officers and directors is premised on a conclusive presumption that the control they exercise over their corporations affords them access to inside information. The proposal's refusal to permit officers or directors to share in the affirmative defense accords with the original legislative intent. As the Supreme Court noted in *Kern County Land Co. v. Occidental Petroleum Corp.*, 411 U.S. 582 (1973), *aff'd sub nom.* Kern County Land Co. v. Occidental Petroleum Corp., 411 U.S. 582 (1973). As the Supreme Court in *Kern* noted: "If there are evils to be redressed by way of deterring those who would make tender offers, § 16(b) does not appear . . . to have been designed for this task." 411 U.S. at 597-98.

79. Although gifts, because they lack consideration, are exempt from the statutory definitions of purchase and sale, see p. 1440 and notes 61 & 62 supra, an insider who receives a gift of securities might nonetheless profit by selling these securities within six months on the basis of inside information and escape § 16(b) liability. See *Shaw v. Dreyfus*, 172 F.2d 140, 143 (2d Cir.) (Clark, J., dissenting), *cert. denied*, 337 U.S. 907 (1949) (expressing concern that gift exclusion would offer "considerable inducement" to insider to speculate on advance information); *Blau v. Albert*, 157 F. Supp. 816, 820 (S.D.N.Y. 1957) (denying summary judgment for defendant; issue of fact whether gifts bona fide). Remedies for such abuses would therefore be left to state law, see note 9 supra, and Rule 10b-5 actions, see note 98 infra. The same would be true of other transactions specifically excluded from § 16(b) by Congress or the SEC.


81. One student commentator has argued that "[t]he solution [to contemporary § 16(b) problems] . . . is to allow the defendant to raise as defenses the factors which *Kern County* forces the plaintiff to prove as part of his cause of action." 49 N.Y.U.L. Rev. 353, 372 (1974). This proposal suffers from two serious drawbacks. First, *Kern* and subsequent cases
Exceptions to Section 16(b) Liability

most-McKesson, “Congress thought that all short-swing trading by directors and officers was vulnerable to abuse because of their intimate involvement in corporate affairs. But trading by mere stockholders was viewed as being subject to abuse only when the size of their holdings afforded the potential for access to corporate information.”82 This distinction, the Court concluded, “simply reflect[s] the realities of corporate life.”83

As the Court suggested, the assumptions underlying the presumption of access to inside information are weaker with respect to beneficial owners than with respect to officers and directors. Indeed, during the congressional hearings, the principal issue of insider status concerned the percentage of stock ownership at which a beneficial owner would exercise control substantially equivalent to that of an officer or director.84 Although recognizing that even a large stockholder might not necessarily exercise control over a corporation,85 Congress eventually settled on a ten-percent interest as that which would support an irrefutable presumption of access to inside information.86 But in fact, as Kern and related cases have demonstrated, one cannot draw any such line with certitude.

The distinctions between beneficial owners and other statutory insiders on the basis of control and access to inside information become explicit in a related section 16(b) context, the issue of when one becomes a statutory insider.87 In resolving that issue, the courts have also
turned to the legislative history to support a restrictive interpretation of beneficial owner status.\textsuperscript{88} Compared to a beneficial owner, "a director or officer can usually stimulate more directly actions which affect stock values and have knowledge of factors which might depress values."\textsuperscript{89} Furthermore, as Foremost-McKesson\textsuperscript{90} and Kern attest, courts have closely examined when the status of the beneficial owner justifies the statutory presumption of control sufficient to afford access to inside information.

A distinction between controlling and noncontrolling shareholders is also evident in related areas of the securities laws. In Piper v. Chris-Craft Industries, Inc.,\textsuperscript{91} the Court distinguished, on the basis of control, between stockholders in the same statutory category under section 14 of the Securities Exchange Act.\textsuperscript{92} In order to achieve its view of the original legislative purpose, the Court held that a defeated tender offeror had no implied cause of action under section 14(e) because, although a shareholder, the tender offeror was not an intended beneficiary of the Act.\textsuperscript{93}

Thus one solution to contemporary problems of section 16(b) interpretation is to allow the noncontrolling beneficial owner the affirmative defense of lack of access to inside information, rather than to rely on the unpredictable results of the transactional approach. To avoid section 16(b) liability, the beneficial owner should be required to establish two facts. First, he must show that he does not exercise control over the corporation comparable to that exercised by an officer or

---

exception to this rule is Gold v. Sloan, 486 F.2d 340 (4th Cir. 1973), cert. denied, 419 U.S. 873 (1974), discussed in note 40 \textit{supra}, where the court excused some of the defendants, even though they were officers or directors at one end of the short-swing transaction, from liability under § 16(b).


90. As the Court in Foremost-McKesson noted, it would be inconsistent with the statutory distinction between "short-term trading by mere stockholders and such trading by directors and officers" to impose liability for transactions made before the requisite stock interest giving rise to a presumption of access to inside information had been acquired. 423 U.S. at 253-54 & n.28.


93. 430 U.S. at 42.
Exceptions to Section 16(b) Liability

director. Should he fail to do so, he is liable. Should he succeed, he must then show he had no access to inside information. Only then would he be exonerated. The severe burden of proving the two negatives that this test places on the beneficial owner represents the minimum departure possible from the strict, categorical liabilities mandated by the explicit legislative intent. Furthermore, the requirement of showing the absence of access to inside information prevents the noncontrolling beneficial owner who may nonetheless have access to such information from profiteering through its misuse. Moreover, the proposed test avoids shifting the difficult burden of proving actual use of inside information to the section 16(b) plaintiff—a problem that, together with the burden of proving an intent to speculate, has plagued Rule 10b-5 litigation and that would create the very difficulties that section 16(b) was designed to avoid.

94. The burden to be met is that of a hostile management opposed to the interests of the beneficial owner. See Kern County Land Co. v. Occidental Petroleum Corp., 411 U.S. 582, 585-86, 598-99 (1973); American Standard, Inc. v. Crane Co., 510 F.2d 1043, 1053-54 (2d Cir. 1974), cert. denied, 421 U.S. 1000 (1975).

95. The requirement of a hostile management alone is not sufficient because of the possibility of obtaining access to inside information through negotiations with the opposing parties. See Kern County Land Co. v. Occidental Petroleum Corp., 411 U.S. 582, 599 (1973); American Standard, Inc. v. Crane Co., 510 F.2d 1043, 1054 (2d Cir. 1974), cert. denied, 421 U.S. 1000 (1975). But cf. 49 N.Y.U.L. Rev. 353, 362 (1974) (arguing that Occidental may have had access to inside information).


97. See pp. 1436-37 & notes 36-40 supra.

98. Rule 10b-5, 17 C.F.R. § 240.10b-5 (1977), issued by the SEC pursuant to § 10(b) of the Securities Exchange Act, 15 U.S.C. § 78j(b) (1970), prohibits fraudulent or manipulative schemes “in connection with the purchase or sale of any security.” The scope of Rule 10b-5 is not limited to corporate insiders or pairs of short-swing transactions; it thus extends beyond that of § 16(b). Nonetheless, a Rule 10b-5 action is substantially more difficult to maintain, and there are significant differences in the burden of proof. A plaintiff under Rule 10b-5 must meet the strict standing requirement of Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 754-55 (1975) (limiting standing under Rule 10b-5 to purchasers or sellers of securities), he must show that the insider actually traded on the basis of inside information, SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 882 (2d Cir. 1968), cert. denied, 394 U.S. 976 (1969), and he must establish scienter, Ernst & Ernst v. Hochfelder, 425 U.S. 185, 201-06 (1976). Indeed, the Texas Gulf Sulphur litigation serves as a prime example of the difficulties in proving the existence and materiality of inside information that Congress sought to avoid by enacting § 16(b):

Finally, a major factor in determining whether the K-55-1 discovery was a material fact is the importance attached to the drilling results by those who knew about it. This insider trading activity, which surely constitutes highly pertinent evidence and the only truly objective evidence of the materiality of the K-55-1 discovery, was apparently disregarded by the court below in favor of the testimony of defendants' expert witnesses, all of whom “agreed that one drill core does not establish an ore body, much less a mine”... 401 F.2d at 851 (citation omitted).
Conclusion

This proposal has the virtue of harmonizing most of the judicial resistance to section 16(b)'s strict liabilities with the underlying congressional fears that led to its enactment. By inquiring, on an ad hoc basis, into the potential for abuse inherent in particular transactions, Kern effects a much more drastic—and much less useful—judicial revision of the statute than would the proposal of this Note. Transactional analysis provides a poor measure of potential for speculative abuse; moreover, neither the legislative history nor the statute itself offers support for narrowing the statutory definitions of purchase and sale comparable to that for limiting the liabilities of noncontrolling beneficial owners. The "brightline" liabilities of section 16(b) were intended to remove completely any possibility of short-swing trading by controlling insiders on the basis of inside information, but these liabilities have been rendered ambiguous and uncertain by judicial preoccupation with the form of particular transactions—an unreliable indicator of potential for speculative abuse. This Note's systematically defined exceptions to liability under section 16(b) would return certainty and predictability to a statute intended to have clear and unambiguous application.

99. Insofar as the issue was considered at all, the congressional hearings reveal that Congress clearly recognized that § 16(b)'s categorical liabilities might work hardships in individual transactions. See note 2 supra (Thomas G. Corcoran).

100. Section 16(b) explicitly encompasses "any purchase and sale, or any sale and purchase" by a statutory insider where both transactions are completed within a six-month period. 15 U.S.C. § 78p(b) (1970) (first sentence). But see SEC v. National Sec., Inc., 393 U.S. 453, 466 (1969) (meaning of securities provisions must be determined in context; "same words may take on a different coloration in different sections").