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Insider Liability for Short-Swing Profits: The Substance and Function of the Pragmatic Approach

Section 16(b) of the Securities Exchange Act of 1934 seeks to deter short-swing stock speculation by corporate insiders who have advance knowledge of a change in the value of their issuer's securities. "Insiders"—officers, directors, and beneficial owners of more than ten per cent of the stock of a corporation—may be divested of profits.

For the purpose of preventing the unfair use of information which may have been obtained by such beneficial owner, director, or officer by reason of his relationship to the issuer, any profit realized by him from any purchase and sale, or any sale and purchase, of any equity security of such issuer (other than an exempted security) within any period of less than six months, 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.


3. Securities Exchange Act of 1934, § 16(a), 15 U.S.C. § 78p(a) (1970): "Every person who is directly or indirectly the beneficial owner of more than 10 per centum of any class of equity security (other than an exempted security) which is registered pursuant
made from a purchase and sale, or sale and purchase, of their issuer's stock where both the purchase and sale have occurred within a six-month period. On its face, section 16(b) is easy to apply: Consideration of the insider's intent to speculate is explicitly barred, and proof of actual abuse of inside information has been uniformly held to be irrelevant. 4

However, there has been an increasing realization that some instances of insider trading, although they apparently fall within the strict terms of the statute, should not be subject to the "crushing liabilities" 5 that the statute imposes. Increased flexibility in applying section 16(b) has, so far, centered around the treatment of "unorthodox" transactions 6—noncash transactions such as stock conversions, the grant or exercise of stock options, and stock exchanges pursuant to mergers, which do not clearly fall within the statutory definitions of "purchase" and "sale." 7 Early cases, using a so-called "objective approach," 8 dealt with unorthodox transactions in a mechanical fashion, without considering the circumstances surrounding the particular transaction in light of the statutory purpose. 9


6. The term "unorthodox transactions" is perhaps attributable to 2 L. Loss, SECURITIES REGULATION 1069 (2d ed. 1961), and is an accepted part of the section 16(b) vocabulary, see Kern County Land Co. v. Occidental Petroleum Corp., 411 U.S. 582, 593 n.24 (1973).


8. The terms "objective," "subjective," and "pragmatic" are also part of a well-accepted nomenclature for various approaches to the application of section 16(b). See Kern County Land Co. v. Occidental Petroleum Corp., 411 U.S. 582, 593 n.24 (1973); Gold v. Sloan, 486 F.2d 340, 343 (4th Cir. 1973); Comment, Stock Exchange Pursuant to Corporate Consolidation: A Section 16(b) "Purchase or Sale," 117 U. PA. L. REV. 1034, 1036-39 (1969).

9. Typical of the objective approach is the following language of Judge Clark in Park & Tilford, Inc. v. Schulte, 160 F.2d 984 (2d Cir.), cert. denied, 332 U.S. 761 (1947), where the court held that a conversion of certain preferred stock into common stock was a section 16(b) purchase: "Defendants did not own the common stock in question before they exercised their option to convert; they did afterward. Therefore they acquired the
More recently, a second, "pragmatic," approach has been developed, which inquires "whether the transaction may serve as a vehicle for the evil which Congress sought to prevent." Therefore, the possibility of abuse of inside information, drawn from the circumstances surrounding the defendant's transactions, is the test for liability. The existence of possibility of abuse is determined, for instance, by asking whether the defendant had access to inside information, whether the information was adequately disclosed, or whether the transaction was simply a continuation of a prior investment.

In Kern County Land Co. v. Occidental Petroleum Corp., the Supreme Court adopted a form of the pragmatic approach. In determining whether certain transactions constituted "sales" within the meaning of section 16(b), the Court looked to whether they had potential for speculative abuse. However, the Court's discussion leaves stock, within the meaning of the Act." Accord, Heli-Coil Corp. v. Webster, 392 F.2d 156 (8d Cir. 1968); Kern County Land Co. v. Occidental Petroleum Corp., 411 U.S. 582, 605 (1973) (Douglas, J., dissenting); Petteys v. Butler, 367 F.2d 528 (8th Cir. 1966) (Blackmun, J., dissenting), cert. denied, 385 U.S. 1006 (1967).


16. Kern County involved a tender-offeror (Occidental) that was trapped into an exchange of securities by a defensive merger on the part of the target corporation (Old Kern). The situation was complicated by an option agreement between Occidental and Tenneco, Inc., the company which finally acquired Old Kern, by which Tenneco received an option on all of the Tenneco stock that Occidental would receive in exchange for its Old Kern shares upon consummation of the Old Kern-Tenneco merger. Occidental's liability under section 16(b) was asserted on two theories: (1) Occidental had purchased more than ten per cent of Old Kern's stock pursuant to its tender offer, making it a "beneficial owner" within the terms of the statute (see note 3 supra) and had followed the purchase with a "sale" within six months after the date that Occidental became "insider" by acquiring more than ten per cent of Old Kern's stock. 411 U.S. at 595-96.

The majority of the Court (Justices Douglas, Stewart, and Brennan dissented) rejected both theories on the ground that neither alleged "sale" could have been used as
the substantive requirements of the test unclear, and its use of the test for the narrow purpose of deciding whether a transaction is a "purchase" or "sale" raises serious questions.

This Note will discuss the inquiries encompassed by the "possibility of abuse" test. It will also evaluate whether the test is properly employed only in determining that an unorthodox transaction is or is not a "purchase" or "sale" or whether the test could better be used as a threshold inquiry in all cases.

As a preliminary matter, no abuse is possible if the form of the defendant's transactions provides no opportunity for the use of inside information. In other words, the defendant's "purchase" and "sale" must both represent a discontinuity of investment—the purchase must create a new opportunity for profit, and the sale must allow a realization of that profit if a possibility of abuse is to be found.

To illustrate, suppose Bishop, a director of Chess Corporation, purchases 1,000 shares of Chess convertible preferred stock on January 2. On May 1, Bishop converts the preferred stock into common because Chess has called the preferred stock at a price below market. The price of both preferred and common Chess stock has risen because Chess has called the preferred stock at a price below market. The price of both preferred and common Chess stock has risen because Chess has called the preferred stock at a price below market.

a vehicle for speculative abuse; hence, neither transaction was a "sale." With respect to Occidental's acquisition of the right to exchange its Old Kern shares the Court argued that Occidental had no inside information before its tender offer since it was not yet an insider. Furthermore, Occidental could have gained no inside information even after it became a beneficial owner of over ten per cent, because the Old Kern management was its antagonist, rather than its confidant. 411 U.S. at 596-99. A "critical fact" was the involuntary nature of the merger, so far as Occidental was concerned, since Occidental had neither control of nor participation in the transaction. 411 U.S. at 599-600. With respect to the option agreement, the Court emphasized first, that the alleged "sale" was to the new owners of Old Kern, who undoubtedly had more information about Old Kern than did Occidental. 411 U.S. at 602. Second, the option granted was a "call" rather than a "put." If the price of the optioned stock fell more than ten dollars per share Tenneco could fail to exercise the option and the shares would remain with Occidental. If the price rose Tenneco would buy the shares at the option price, and Occidental would have made an unfavorable bargain. 411 U.S. at 602. Third, the option covered not Old Kern stock but the Tenneco preference stock to which Occidental became entitled pursuant to the merger. Even if Occidental did have inside information about Old Kern it had no inside information as to the future value of its prospective Tenneco holdings. 411 U.S. at 602-03. Fourth, no inside information would have been useful in any case since the option could not be exercised for at least six months, a period that the statute presumes long enough to dissipate the usefulness of inside information. 411 U.S. at 603. Finally, the premium paid for the option was reasonable in light of expert evaluations of the option's worth and was not large enough to make exercise of the option a virtual certainty. Nor was the giving of the option accompanied by the surrender of voting rights or the passing of other emoluments of ownership that would indicate that the option was in fact a sale in disguise. 411 U.S. at 603-04.


18. This formulation is valid where an investor's purchase is matched with a later sale. In sale-purchase situations, on the other hand, it is the sale that creates the opportunity for profit and the purchase that completes the realization.

tween January 2 and May 1 because of technological discoveries announced by Chess on January 15 but known to Chess directors before January 2. Should Bishop be liable for short-swing profits on the theory that his conversion was a "sale" for purposes of section 16(b)?

The answer should depend on whether Bishop's conversion was a simple continuation of his former investment. If Bishop had sold for cash rather than converting his stock he clearly would have made a sale because his assets would no longer be subject to an investment risk. If, when Bishop converted, the prices of Chess common and preferred stock were completely interdependent, his holdings before and after the conversion would be "economic equivalents"; his situation would be the same as if he bought Chess preferred stock on January 2 and simply retained it for more than six months. If the price of common and preferred stock did vary independently, however, Bishop would have significantly changed his investment, and his conversion should be regarded as a sale. Logically, this analysis should also extend to exchanges of stock pursuant to merger. Where an investor trades stock in corporation A for stock in corporation B he has usually made a "sale" of A stock and a "purchase" of B stock because his investment will have changed substantially. Where A and B are essentially the same corporation in different forms, however, the investor should face no liability. The Securities and Exchange Commission has codified this analysis by exempting from section 16(b) "acquisitions and dispositions of securities pursuant to mergers or consolidations" where the acquiring company owned eighty-five percent of the securities or assets of the acquired company prior to the merger.

If the "possibility of abuse" test is used solely to determine whether a given unorthodox transaction is a "purchase" or "sale," this limited inquiry into continuity of investment may be sufficient.

20. The answer would be "no" under 17 C.F.R. § 240.16b-9 (1973), an exemption for certain conversions established by the Securities and Exchange Commission in 1966. The rule will be ignored for the purposes of this hypothetical.


22. In such a case, of course, section 16(b) would not apply. The defendant is not exonerated because he did not purchase on the basis of inside information; Bishop may, indeed, have purchased with Chess' discoveries in mind. The point is that the statute does not punish purchases that are not followed by sales within six months, partly because the draftsmen did not want to discourage long-term investment and partly because they assumed that, if an investor waits for six months before selling, any information he may have will have outlived its usefulness. See text accompanying note 46 infra.


However, in a broader sense, the "possibility of abuse" test could be used—in cases involving orthodox, as well as those involving unorthodox transactions—to determine whether it is appropriate to subject the defendant to liability under section 16(b) at all. When it is used in this sense, the test properly encompasses inquiries beyond mere continuity of investment.

In defining what is meant by "possibility of abuse" in a broader sense, however, one must first examine the nature of the "abuse" that Congress sought to reach by enacting section 16(b).

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26. One important issue must be resolved first. It is characteristic of the amorphous state of the "possibility of abuse" test that the word "possibility" has more than one interpretation. It may mean that courts should examine the defendant's transactions and decide whether there is a possibility that the defendant actually did trade on the basis of inside information. On the other hand, "possibility" may be used in the sense of "opportunity," allowing courts to inquire whether someone in the defendant's position could have taken advantage of inside information, even though it may be clear that the defendant himself did not. In most cases either formulation will lead to the same result. Where the defendant could have had no inside information before his initial purchase or sale there is no chance that he actually traded on inside information, and there was never any opportunity for him to do so. See, e.g., Kern County Land Co. v. Occidental Petroleum Corp., 411 U.S. 585 (1973), discussed in note 16 supra. Suppose, however, that insider X received information on June 1 about an important event to occur on July 1 that will raise the price of his issuer's stock. He keeps the information secret until June 15, when it is disclosed in a proxy statement. He buys on June 20 and sells on July 31, still turning a profit because the market was slow to realize the significance of the disclosure. Is there a possibility of abuse? Certainly when X made his purchase, the information that led him to do so was not "inside" information, but X did have an opportunity to trade on advance knowledge between June 1 and June 15.

The Fourth Circuit, on analogous facts, recently found a possibility of abuse in Gold v. Sloan, 466 F.2d 340 (1973). A director of Atlantic Research Corporation (ARC), Arthur Sloan, gained access to the books, records, and physical plant of Susquehanna Corporation prior to Susquehanna's merger with ARC. The court found that Sloan had thus acquired "specific financial information . . . that would have helped him to predict the future performance of Susquehanna stock." 466 F.2d at 352. The court acknowledged, however, that Sloan's information was distributed to all ARC shareholders in a proxy statement of October 26, 1967, relating to the proposed merger. Sloan made no purchase of ARC or of Susquehanna stock until the merger was closed on December 4, 1967, when some ARC stock that he had acquired years earlier was exchanged for Susquehanna stock pursuant to the merger agreement. Within six months of this exchange, he sold some of the Susquehanna stock for cash. While Sloan did have the opportunity to speculate prior to October 26, he did not do so, and there was no showing that his "purchase" in December was based on information that had not been made public over a month before. Nevertheless, the court held that "[d]uring this . . . period [that is, before October 26], when stockholders generally were uninformed about Susquehanna and its financial condition and prospects, Sloan was in possession of information secured by an examination of Susquehanna's records and inspection of its plants that gave him superior knowledge about the financial condition of Susquehanna and its prospects. He thus did have an opportunity for abuse of inside information." 466 F.2d at 352. In such situations it is more consistent with the purpose of the statute and the goal of avoiding harshness to find no "possibility of abuse," provided that the insider has allowed outsiders a reasonable time to "absorb and evaluate disclosures" before purchasing himself. Cf. SEC v. Texas Gulf Sulphur Co., 401 F.2d 835, 854 n.18 (2d Cir.), cert. denied, 394 U.S. 976 (1969). Furthermore, it is hard to reconcile the meaning of "possibility of abuse" as used in Gold with the test as it is set forth by Kern County and other cases using the "pragmatic" approach. See, e.g., Blau v. Lamb, 303 F.2d 597, 521 (2d Cir. 1962), cert. denied, 305 U.S. 1022 (1967): "As controlling insiders [the defendants] clearly had the power to
Superficially, the evils that led to the enactment of section 16(b) are plain. The subsection declares its purpose to be "preventing the unfair use of information which may have been obtained by [a corporate insider] by reason of his relationship to the issuer," and an early case states that "§ 16(b), specifically, was designed to protect the 'outside' stockholders against at least short-swing speculation by insiders with advance information." The congressional committees that recommended the enactment of section 16(b) emphasized the situation in which an insider would learn about, or even plan to create, a future price rise in his issuer's stock, purchase while the price was still low, and sell later to reap a virtually certain profit. This sort of abuse is clearly encompassed by the statute. Its key feature is that the investor has inside information before he makes his initial purchase or sale; he is motivated to begin his short-swing by advance knowledge. This situation may be termed "double-transaction abuse," because the advance information has influenced both the insider's first transaction — where the opportunity for profit is created — and his second transaction — where the profit is realized. A different situation is presented by the investor who makes his purchase with no specific information about future price changes, but who receives such information before his sale. The inside information may still be exploited. The purchaser may, for instance, temporarily refrain from selling his stock after learning about an impending rise in its price. The advance information, however, influences only a single transaction.
tion—the final sale—and, therefore, the situation involves at the most only "single-transaction abuse."

It is not entirely clear that section 16(b) reaches single- as well as double-transaction abuses. The following hypothetical case demonstrates a situation in which the investor will be subject to section 16(b) liability only if the statute's reach extends to both types of abuse. Assume investor Pawn purchases one hundred shares of the stock of Chess Corporation for thirty dollars a share on January 1. This purchase does not make Pawn an insider, but he becomes one on April 1 when he is named to the Chess board of directors. On April 15, Pawn receives information that Chess will merge with Checkers Corporation during the last few weeks of June. This information is not made public until May 1, and the merger is closed as planned on June 25; Pawn thereby becomes a holder of one hundred shares in the surviving company (Games), whose shares have a market value of sixty dollars. Pawn has made a substantial profit because the exchange rate was tied to the June 25 price of Chess stock, which, as Pawn could have foreseen on April 15, was much higher than the pre-announcement price. Games Corporation brings suit against Pawn under section 16(b), alleging that he has made a profit by buying and selling Chess stock within six months. The principle issue is whether Pawn "sold" his Chess stock within the meaning of the statute when it was transmuted into Games stock pursuant to the merger.\(^{30}\) The test set forth in Kern County is whether Pawn's transactions reflect a possibility of abuse. If section 16(b) deals only with double-transaction abuse the exchange should not be held to be a "sale" for purposes of section 16(b); unless other facts are shown, it is reasonable to assume that Pawn's initial purchase was entirely unrelated to the future price rise.\(^{31}\) There is, in other words, no possibility of double-transaction abuse. However, if section 16(b) also deals with single-transaction abuse, the result would be different. Although Pawn may otherwise have sold his stock between April 15 and May 1, his knowledge of the forthcoming merger may have led him to retain the stock until after the merger was announced. To the extent Pawn possessed inside information that enabled him to "time" his sale he

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\(^{30}\) Pawn could claim that section 16(b) does not apply to him because he was not an insider at the time he purchased. Such a claim, however, has been rejected in a number of cases. See, e.g., Marquette Cement Mfg. Co. v. Andreas, 229 F. Supp. 962 (S.D.N.Y. 1965); Adler v. Klawans, 172 F. Supp. 502 (S.D.N.Y. 1958), affd., 267 F.2d 840 (2d Cir. 1959); Blau v. Allen, 163 F. Supp. 762 (S.D.N.Y. 1958). See also 2 L. Loss, supra note 6, at 1060-61; W. PAINTER, FEDERAL REGULATION OF INSIDER TRADING 39-40 (1969). This issue is discussed in the text accompanying notes 85-91 infra.

\(^{31}\) The result should, perhaps, be different if it could be established that Pawn was the moving or controlling force behind the merger. It would then be not unlikely that he knew at the time of his purchase that he would be able to engineer a merger that would increase the price of his shares. See notes 88-89 infra and accompanying text.
enjoyed an unfair advantage over other Chess shareholders, and thus his exchange involves a possibility of single-transaction abuse.

No court has dealt explicitly with the distinction between single- and double-transaction abuse, but a comparison of several cases indicates that there is a good deal of confusion about the problem. *Stella v. Graham-Paige Motors Corp.* suggests that single-transaction abuse may be irrelevant in the section 16(b) context. That case dealt with an outsider that assumed insider status by purchasing stock sufficient to make it a beneficial owner of over ten per cent of the issuer's outstanding stock. The purchase was followed within six months by a sale, and suit was brought against the investor under section 16(b). The defendant claimed that, since it was not an insider prior to its purchase, it was exempted under the statutory provision precluding liability for "any transaction where such beneficial owner was not such both at the time of the purchase and sale . . . of the security involved." The district court noted that the phrase "at the time of" could mean either "prior to" or "simultaneously with." It accepted the latter interpretation and construed the statute to include the very purchase that makes one an outsider. Such a construction could be easily supported if it is assumed that section 16(b) reaches single-transaction abuse. The fact that an investor was not an insider when he made his initial purchase is irrelevant if a possibility of abuse in the later sale—made after he became an insider and when he may have had inside information allowing him to time his sale—is sufficient to bring him within the reach of the statute. The court was not concerned, however, with the possibility of single-transaction abuse, even though it was certainly present. Rather, the court emphasized that the opposite result would allow an owner of over ten per cent of the stock who wanted to act on advance information to avoid liability by selling out to below ten per cent before making a short-swing purchase and sale. The court was disturbed by the opportunity for dou-

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24. 104 F. Supp. at 959:

If the construction urged by defendant is placed upon the exemption provision, it would be possible for a person to purchase a large block of stock, sell it out until his ownership was reduced to less than 10% and then repeat the process, ad infinitum. A construction such as this would provide a way for the evasion of § 16(b) by principal stockholders, and render it largely ineffective to prevent some of the financial evils which led to the passage of this legislation by Congress.

In other words, a shareholder with over ten per cent could gain advance information about a price rise. Acting upon this information, he could sell out to below ten per cent and shortly thereafter repurchase even more shares than he originally held. This sale and purchase, though covered by section 16(b), would likely be inconsequential, since the price of the stock would not yet have risen. It would rise shortly thereafter, but the investor could sell and take his profit with impunity if the repurchase were exempt under section 16(b) because he was not an insider immediately prior to it. For a further discussion of this situation, see text accompanying notes 92-106 infra.
ble-transaction abuse left open by the defendant's argument; the opportunity for single-transaction abuse was ignored.\footnote{35}

Other cases, however, strongly suggest that single-transaction abuse is reached by section 16(b). In \textit{Kern County} the Supreme Court found that the defendant's initial purchase was made without an opportunity to acquire inside information.\footnote{36} If the Court had only been willing to consider double-transaction abuse, its inquiry would have stopped there. However, it went on to consider whether there was a possibility of abuse in the defendant's alleged section 16(b) "sales"—its grant of an option on shares that it would acquire pursuant to a merger and the merger exchange itself. The Court eventually found no possibility of abuse at any stage, but the very fact that an inquiry was made into all three transactions indicates that the Court thought that the possibility of single-transaction abuse would have been sufficient to impose liability. The Fourth Circuit, in \textit{Gold v. Sloan},\footnote{37} dealt more directly with single-transaction abuse. The opinion states that the pragmatic approach "requires as a basis for statutory liability that the specific transaction itself, which constitutes the unorthodox transaction, present the possibility of, or potential for, exploitation of insider information."\footnote{38} Finally, the Second Circuit, in \textit{Newmark v. RKO General, Inc.},\footnote{39} arriving at the same conclusion it had accepted arriving at the same conclusion it had accepted

\footnote{35. The opportunity for single-transaction abuse was explicitly found to be outside the statute's scope by Judge Hincks, who dissented from the Second Circuit's reversal of a subsequent district court holding in \textit{Stella}:}

\textit{[T]he basic rationale of the Act was such that only completed swing transactions gave rise to the presumption of unethical use of advance information: if one purchased stock on one day, became a director on the next, and sold some of his stock on the next, any resulting profit was not recoverable by the corporation apparently because a sale alone was thought to be insufficient basis for a drastic presumption that it had been made in violation of a fiduciary duty.} \textit{Stella v. Graham-Paige Motors Corp., 232 F.2d 299, 305 (1956), revg. on other grounds 132 F. Supp. 100 (S.D.N.Y. 1955) (emphasis added).}


\footnote{36. 411 U.S. at 596-97. For a summary of the facts and holding of the case, see note 16 supra.}

\footnote{37. 486 F.2d 340 (1973). The Gold case is discussed in note 25 supra.}

\footnote{38. 486 F.2d at 343 (emphasis original).}

The dissenting judge in \textit{Gold} is still more explicit. He notes cases that have held a director liable for profits under section 16(b) even though he was not a director at the time of his initial purchase and goes on to state that "[t]he application of § 16(b) to such cases can be supported only on the theory that the possible use of inside information, acquired during the period between the defendant's service as a director and his subsequent closing sales, in order to time those sales as advantageously as possible, was one of the kinds of abuse Congress sought to prevent." 486 F.2d at 356 (Winter, J., dissenting in part). Cf. \textit{Greene v. Dietz}, 247 F.2d 689, 693 (2d Cir. 1957).

\footnote{39. 425 F.2d 348, cert. denied, 400 U.S. 854 (1970).}
earlier in Stella, based its discussion solely on the possibility of single-transaction abuse:

The statutory reference to a ten per cent beneficial owner rests on the presumption that an owner of this quantity of securities has access to inside information. Although this presumption would not justify the conclusion that one who purchases a quantity of shares which makes him a ten per cent beneficial owner has done so on the basis of inside information, the presumed access to such information resulting from this purchase provides him with an opportunity, not available to the investing public, to sell his shares at the moment most advantageous to him. Thus, a purchase of shares which makes the buyer an insider creates an opportunity for the type of speculative abuse the statute was enacted to prevent.40

The cases suggest that single-transaction abuse should be included within the scope of section 16(b), but, if they shed any light, they do so only incidentally, for they neither distinguish the two forms of abuse nor expressly reach the question of which form is included by the statute.

A direct analysis of the problem must include the following inquiries: (1) Was section 16(b) intended by Congress to deal with single-transaction abuse? (2) Assuming arguendo that the legislative intent is in any way unclear, should the courts extend the section to cover such abuse? The issue of legislative intent may be addressed by examining the terms of the statute and its legislative history, both of which indicate that only double-transaction abuse was intended to be reached. The congressional hearings and reports discussing the provision eventually enacted as section 16(b) repeatedly describe its purpose in terms referring to double- rather than single-transaction abuse—the curbing of “short-term,” “in-and-out” speculation on the basis of inside information.41 Furthermore, the examples in the con-

40. 425 F.2d at 356.
41. Section 16(b) “[f]orbs [the insider] to carry on any short-term speculative transactions in the stock. He cannot with his inside information get in and out of stock within six months.” Hearings on H.R. 7332 and H.R. 8720 Before the House Comm. on Interstate and Foreign Commerce, 73d Cong., 2d Sess. 133 (1934) (statement of Thomas Corcoran). Section 16(b) “is to prevent directors receiving the benefits of short-term speculative swings on the securities of their own companies, because of inside information.” Hearings on S. Res. 84, S. Res. 56, and S. Res. 57 Before the Senate Comm. on Banking and Currency, 73d Cong., 2d Sess., pt. 15, at 6657 (1934) [hereinafter Senate Hearings] (statement of Thomas Corcoran).

Furthermore, many references to the evil that led to the enactment of section 16(b) expressly speak of an intent to speculate at the time of the initial transaction. There are, for instance, these passages from the deliberations over the inclusion of a “sale and purchase” provision as well as a “purchase and sale” clause:

Senator BULKLEY. Do you provide for [the case] where a man might sell for a short term with the intention of repurchasing? . . .

. . . .

It would not be selling short. He might be a large stockholder, and sell his own stock with the intention of repurchasing.
gressional hearings and reports of the kind of abuse intended to be reached by section 16(b) include no instances of single-transaction abuse, but in all cases describe situations in which advance information tainted both the purchase and the sale.\textsuperscript{42}

The case from the statute itself is even more clear. First, the statute speaks in conjunctive terms of "profit realized . . . from any purchase and sale, or sale and purchase . . .,"\textsuperscript{43} implying that Congress did not intend section 16(b) to deter abuse of inside information in a single transaction unless the abuse was converted into a trading profit by means of a second transaction.\textsuperscript{44} This implication is supported by

\textit{Mr. Corcoran. The bill does not cover that case. . . . Usually men are not as ready to sell a stock with the expectation of picking it up on the downgrade as they are to buy a stock on what they think is going to be a rise in the market. Senate Hearings, supra, at 6557-58 (emphasis added).}

Some language in the congressional literature is broad enough to encompass single-transaction abuse. See, e.g., \textit{Sen. Rep. No. 1455, supra} note 29, at 68: "By this section it is rendered unlawful for persons intrusted with the administration of corporate affairs or vested with substantial control over corporations to use inside information for their own advantage." However, this general language is also compatible with double-transaction abuse, and the weight of the evidence suggests that no implication of concern about single-transaction abuse be drawn from it.


Much of the insider abuse involved participation in so-called "poole," which were dummy accounts in a corporation's stock established to buy and sell, at the same time, and at a frenetic pace. By so churning the account, it was often possible to engineer a false impression of immense activity in the stock, and to arrange spectacular, but artificial, price rises. One pool bought and sold almost 1,500,000 shares of RCA stock in a single seven-day period in 1939, at a net profit to its members of almost $2,000,000 . . . . Another famous pool involved the stock of the American Commercial Alcohol Company. During the summer of 1933, eight insiders and their associates reaped a profit of $300,000 on an investment of $62,000. A third pool, in a stock of the Fox Film Corporation, made $2,000,000 in five months. This pool was notable for the extent to which large stockholders participated. Perhaps the most famous of the short-swing speculators was Albert H. Wiggin, chairman of the governing board of the Chase Manhattan Bank. His stock machinations, all of the double-transaction abuse type, are partially chronicled in \textit{Sen. Rep. No. 1455, supra}, at 62-63.

\textsuperscript{43} 15 U.S.C. \textsection 78p(b) (1970) (emphasis added). This point was stressed, apparently unsuccessfully, in \textit{Adler v. Klawans}, 267 F.2d 940, 949 (2d Cir. 1959).

\textsuperscript{44} There is an argument to the contrary that should be discussed. Perhaps Congress was in fact concerned with abuse of inside information in a single transaction and sought simply to make the transaction unprofitable by surrounding it with a period of six months, both before and after the transaction, where any attempt at realizing a profit would be futile. It is possible, for instance, that Congress was concerned with single purchases tainted by information and therefore outlawed both a sale within the prior six months (a section 16(b) "sale and purchase") and a sale within the next six months (a section 16(b) "purchase and sale"). This is the practical effect of regulating both "purchase and sale" and "sale and purchase" situations. See \textit{Gratz v. Claughton}, 187 F.2d 46, 52 (2d Cir.), \textit{cert. denied}, 341 U.S. 920 (1951). As originally drafted, however, section 16(b) dealt only with the "purchase and sale" situation. See \textit{Senate Hearings, supra} note 41, at 6557-58. The "sale and purchase" addition was made following a suggestion by Senator Bulkeley that the statute as drafted would not deal with the possibility that "[a] man having a large amount of stock might know that his company was going to pass a dividend, and then sell it with the intention of purchasing after the news
the statutory provision for recovery, which provides that the profit realized from a sale of shares is to be calculated with reference to the price paid for their purchase.\textsuperscript{45} Such a scheme is appropriate if the purchase and the sale are part of the same profit-making scheme, that is, if the situation is one of double-transaction abuse. The mechanism is less appropriate, however, for certain instances of single-transaction abuse. Assume, for example, that an insider, in a purchase free of any possibility of abuse, buys stock at 85. The price rises to 100 because of generally favorable economic conditions. At this point the insider becomes privy to advance information about a development that will send the stock price tumbling to 50, so he sells at 100. The recovery under section 16(b) would be 15 dollars per share, but advance information has allowed the insider to avert losses of 50 dollars per share. Thus, the measure of damages is inadequate if the purpose of the statute is to inhibit single-transaction abuses.

A similar analysis applies to the failure of the statute to reach transactions occurring more than six months apart. In situations of double-transaction abuse, where inside information motivates the initial transaction as well as the final one, the six-month time limit is quite reasonable—the inside information typically relates to a temporary price fluctuation and is thus worthless if it cannot be turned to profit within six months. For instance, an investor who receives information in January about a temporary price rise in February will not buy in anticipation of the up-swing if he cannot sell and be assured of retaining his profits until July.\textsuperscript{46} Furthermore, a primary function of the six-month limitation period is "to serve as an indicator of the existence of the prohibited short-swing intention."\textsuperscript{47} The fact that an insider's purchase is quickly followed by a sale makes it more reasonable to assume that the purchase was the beginning of a short-swing based on advance information, rather than a legitimate was out." Id. at 6558. Apparently, then, Congress did not add the "sale and purchase" provision simply as a device to control single-transaction abuse with reference to the purchase. The provision was enacted to deal with a type of double-transaction abuse that had been overlooked.

\textsuperscript{45} "It is plain that [the profit provision] presupposes some matching of (1) purchases against sales, or of (2) sales against purchases . . . ." Gratz v. Clauthon, 187 F.2d 46, 50 (2d Cir.), cert. denied, 341 U.S. 920 (1951). See also Smolowe v. Delendo Corp., 136 F.2d 221, 237 (2d Cir.), cert. denied, 320 U.S. 751 (1943). See generally 2 L. Loss, supra note 6, at 1062-66; Cook & Feldman, supra note 2, at 385.


\textsuperscript{47} Comment, 20 UCLA L. Rev. 1289, supra note 46, at 1296; Comment, 69 YALE L.J. 868, supra note 46, at 876-77.
investment decision. In the context of single-transaction abuse, however, the six-month time limit is illogical. Since the defendant's first transaction is, by hypothesis, completely innocent its only function as a basis for liability is to start the six-month clock ticking. Though the investor may later use inside information in deciding to make a sale, he will not be liable under section 16(b) unless he has made a fortuitous and unrelated purchase within the preceding six months.

Even more convincing is the statutory exemption for securities "acquired in good faith in connection with a debt previously contracted." If Congress was concerned about abuse of inside information with reference to the sale only in the "purchase and sale" situation it would be absurd to create an exception for certain innocent purchases. Indeed, the "debt previously contracted" exemption indicates that when a section 16(b) purchase presents no possibility of abuse, the possibility of abuse with respect to a subsequent sale should be irrelevant.

It may be argued that Congress manifested an intent to deal with single-transaction abuse when it expressly provided that the statute should apply "irrespective of any intention on the part of" the insider not to get out on a short-swing. This provision may be read to indicate that Congress wanted to eliminate any suggestion that some connection in motivation between the purchase and sale was necessary. In fact, the statutory provision cuts the other way. It removes the question of intent from the facts to be considered because Congress feared that requiring the plaintiff to prove the defendant's intent to sell or to disprove his intent not to sell would be too onerous. Therefore, Congress sought to establish an irrebuttable presumption that the two transactions were linked in a single speculative plan.


49. One plausible argument from statutory language that Congress did intend to deal with single-transaction abuse is that the preamble of section 16(b) speaks of a "purpose of preventing the unfair use of [inside] information . . . ." 15 U.S.C. § 78p(b) (1970). This language is broad enough to include single- as well as double-transaction abuse. The preamble must, however, be interpreted in the light of the entire statutory scheme, which, it is submitted, is clearly inconsistent with an intention to regulate single-transaction abuse. See, e.g., Blau v. Max Factor & Co., 342 F.2d 304, 307 (9th Cir.), cert. denied, 382 U.S. 892 (1965); "As section 16(b) itself states, its general purpose is to preclude the 'unfair use of information which may have been obtained by' corporate insiders, in trading in the securities of their corporation. But Congress did not seek to accomplish the whole of this purpose by section 16(b) alone. Section 16(b) creates a special remedy, applicable only in a limited situation."

50. 15 U.S.C. § 78p(b) (1970): Profits shall be recoverable "irrespective of any intention on the part of [the insider] in entering into such transaction of holding the security purchased or of not repurchasing the security sold for a period exceeding six months." Cf. 2 L. Loss, supra note 6, at 1060-61.

51. See Senate Hearings, supra note 41, at 6557 (exchange between Senator Gore and Thomas Corcoran, a principal draftsman of section 16(b)):

Mr. CORCORAN, . . . 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
Despite the case law to the contrary, the terms of the statute and its legislative history establish that section 16(b) is a limited measure directed at "only the most prevalent form of the abuse of inside information—trading designed to take quick profits from short-term market fluctuations."\(^{52}\)

Of course, the unfair use of inside information even in only a single transaction should not be encouraged.\(^{53}\) Therefore, it could be argued that if the statute is found to be unclear—despite the strong arguments to the contrary—the courts should apply section 16(b) to single-, as well as double-, transaction abuse. Certain single-transaction abuses will be deterred even if the courts refuse to take this step. Provable trading on inside information falls within the prohibitions of both the common law\(^{54}\) and the general anti-fraud provisions of

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 intent from the fact.

Mr. Corcoran. From the fact.

(Emphasis added).


The Commission is, of course, aware that section 16(b) is only a partial deterrent to breaches of trust by officers, directors, and principal stockholders. The potentialities of abuse of fiduciary obligations by these corporate insiders are infinite. No complete catalog could ever be made of all the ways in which confidential corporate information can be put to profitable use. It would be virtually impossible to draft a statute which would define and prohibit all of the variations by which officers, directors, or principal stockholders can profit from their trust. It seems to the Commission that the Congress was eminently wise in seeking to deal with the problem by expressly prohibiting only the most prevalent form of the abuse of inside information—trading designed to take quick profits from short-term market fluctuations.

See also W. Painter, supra note 30, at 49; 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, 74-75 (1966); Comment, Reliance Electric, Occidental Petroleum, and Section 16(b): Interpretive Quandary over Mergers, 51 Texas L. Rev. 89, 99 (1972); Comment, 20 UCLA L. Rev. 1289, supra note 46, at 1294-300; Comment, 117 U. Pa. L. Rev. 1034, supra note 8, at 1039 n.39; Casenote, 72 Colum. L. Rev. 1099, 1101 (1972); Casenote, 70 Harv. L. Rev. 1312, 1313 (1957). Contra, Casenote, 57 Colum. L. Rev. 289 (1957); Casenote, 45 Va. L. Rev. 1677, 1679 (1959).


54. The common law cause of action proceeds on the following principle:
the Securities Exchange Act. The benefit gained by extending section 16(b) would be the apprehension and presumed deterrence of single-transaction abuse that would elude both these strictures, in part because of difficulties in proving the existence of the requisite actual abuse. It should be realized, however, that only a small part of this already limited universe could be affected by section 16(b). Under the terms of the statute, single-transaction abuse in a sale, for instance, would be exempt unless a purchase not made in good faith in connection with an antecedent debt had occurred within the previous six months. Because of the statutory damage provision, liability would be further contingent on a rise in the price of the stock between the sale and the earlier purchase or, perhaps, on the payment of dividends, and would be limited to profits made as a result of the rise or the dividends.

Extending section 16(b) to include the abuses falling within the narrow limits described above would involve a considerable cost in terms of equity. Because proof of actual abuse is not required by the statute, recovery under section 16(b) is based on a presumption of

An agent who acquires confidential information in the course of his employment . . . has a duty to account for any profits made by the use of such information, although this does not harm the principle. . . . So, if he has “inside” information that the corporation is about to purchase or sell securities, or to declare or to pass a dividend, profits made by him in stock transactions undertaken because of his knowledge are held in constructive trust for the principal.


55. Perhaps of even greater importance than the common law developments is the growth of rule 10b-5, 17 C.F.R. § 240.10b-5 (1973), adopted pursuant to section 10(b) of the Exchange Act. 15 U.S.C. § 78(j)(b) (1970). There is now little doubt that rule 10b-5 imposes upon the insider a duty to disclose material inside information before trading, even where the trading is not a face-to-face transaction but is effected on a stock exchange. See SEC v. Texas Gulf Sulphur Co., 401 F.2d 833 (2d Cir. 1968), cert. denied, 394 U.S. 876 (1969). The rule certainly covers officers and directors, see, e.g., List v. Fashion Park, Inc., 340 F.2d 457 (2d Cir.), cert. denied, 382 U.S. 811 (1965), and majority or controlling shareholders, see, e.g., Speed v. Transamerica Corp., 99 F. Supp. 808, 828-29 (D. Del. 1951), but its application depends on proof of the actual culpability of the insider. For a general treatment of rule 10b-5 as it relates to insider trading and non-disclosure of material inside information, including references to a wealth of commentary, see R. Jennings & H. Marsh, Securities Regulation: Cases and Materials 1123-32 (3d ed. 1972).

56. See notes 54-55 supra.

57. See note 63 infra.

58. See text accompanying note 4 supra.
abuse arising when an insider buys and sells at a profit within six months. The soundness of the presumption rests on the accuracy of the statute's "crude rule of thumb," that is, on the congruence between the required facts and the implied fact. If the statute were read to reach single-transaction abuse, the required facts would be insufficient to justify the presumption of actual abuse. The occurrence of two transactions within a short time—a fact that would otherwise indicate double-transaction abuse—cannot justify the presumption of guilt when the initial transaction is, by hypothesis, unrelated to the later transaction. Essentially, then, abuse of inside information is presumed merely on the basis of a single purchase or sale by an insider where he has made a fortuitous and clearly innocent purchase at a lower price at some time within the past six months. If such a presumption is sound, so is the presumption that every sale of an issuer's stock by an insider represents an abuse of inside information if the stock sold for a lower price at some time during the preceding six months. If greater protection against single-transaction abuse is necessary, it would be more just to enact a statute specifically directed to that end, rather than to create a "suffocating dragnet" out of a subsection enacted and designed for a limited and different purpose.

An examination of the sorts of inquiries in which courts should engage when applying the "possibility of abuse" test must therefore keep in mind that the test properly refers only to the possibility of double-transaction abuse. In determining whether a defendant should be held liable, the courts must not focus on the "possibility of abuse" inherent in any one transaction at issue. Rather, attention should be directed at the circumstances surrounding both of the defendant's transactions.

59. See note 51 supra.


61. Much of the commentary on section 16(b) agrees that single-transaction abuse is better left outside the scope of the statute on policy grounds. See, e.g., Munter, supra note 52, at 75 ("Whether we decide to reach the good and bad alike or to let them both escape, the insider who is only in on one end should be treated no differently than the insider who engages in only one transaction"); Comment, 20 UCLA L. Rev. 1289, supra note 46, at 1325-26; Comment, 117 U. Pa. L. Rev. 1034, supra note 8, at 1041-42.

62. Gold v. Sloan, 486 F.2d 340 (4th Cir. 1973), illustrates the misperceptions of some courts on this point. Several officers and directors of Atlantic Research Corporation (ARC) received stock in Susquehanna Corporation (Susquehanna) pursuant to Susquehanna's merger acquisition of ARC. The defendants sold some of their Susquehanna stock on the open market within six months of the merger. The issue was whether the exchanges of shares pursuant to the merger were section 16(b) "purchases." The court varied its treatment of the individual defendants, finding a purchase only by the one defendant who "had knowledge [prior to the merger] of certain inside information that would have helped him to predict the future performance of Susquehanna stock." 486 F.2d at 352. This result is consistent with the premise that only the possibility of double-transaction abuse should justify liability. One suspects, however, that the
Perhaps the first question a court should ask is whether the price change that led to the defendant's profits could have been foreseen when he made his initial transaction. If the price change was not foreseeable, it could hardly have been the subject of inside information, and double-transaction abuse would be impossible. The court's analysis is consistent with the double-transaction abuse premise only because of the fortuity that the transaction in question was "the beginning transaction" rather than "the closing or ending transaction." 486 F.2d at 349. The court states that the pragmatic approach "requires ... that the specific transaction itself, which constitutes the unorthodox transaction, present the possibility of, or potential for, exploitation of insider information. ... [I]f there is in the transaction itself, and the negotiations leading up to it, an absence of such possibility of abuse ... liability is not in order." 486 F.2d at 343 (emphasis original). If the merger exchange, then, was the closing transaction, the court presumably would still have found liability if there was a possible misuse of inside information. But this would ignore the fundamental requirement of potential double-transaction abuse—the possibility of abuse must pervade the initial transaction as well as the final one, no matter which transaction is unorthodox.

63. Section 16(b) profits may also include dividends received by the insider. See, e.g., Abrams v. Occidental Petroleum Corp., 323 F. Supp. 570, 582-83 (S.D.N.Y. 1970) (Supp. Opinion 1971), read on other grounds, 450 F.2d 157 (2d Cir. 1971), aff'd, sub nom. Kern County Land Co. v. Occidental Petroleum Corp., 411 U.S. 582 (1973); Marquette Cement Mfg. Co. v. Andreas, 239 F. Supp. 962, 968 (S.D.N.Y. 1965); Western Auto Supply Co. v. Gamble-Skogmo, Inc., 348 F.2d 796, 743-44 (8th Cir. 1965), cert. denied, 382 U.S. 987 (1966). The dividends are not recoverable, however, unless they are "inextricably connected with the 'purchase and sale' of stock and possible manipulation." Adler v. Klawans, 267 F.2d 840, 849-49 (2d Cir. 1959). See also Blau v. Lamb, 363 F.2d 507, 528 (2d Cir. 1966), cert. denied, 385 U.S. 1002 (1967); "[T]he ... dividend was not part of a scheme of short-swing speculation." Lamb, Adler, and Abrams suggest that recovery of dividends is governed by something akin to the "possibility of abuse" test. The analysis that this Note proposes with respect to recovery of profits based on a purchase-sale price differential, therefore, may be congruently applied to "profits made" from dividends.

64. Useful information need not be directly foreseeable to the insider. Indeed, most cases will reflect information available to the issuer's management (often the byproduct of management decisions), which section 16(b) presumes is available to the defendant "by reason of his relationship to the issuer." 15 U.S.C. § 78q(b) (1970). The plaintiff's only burden is to show that the information was available to the issuer generally, that is, that the events causing the price shift were foreseeable to the issuer. Of course, proof that information was foreseeable to the defendant directly is also sufficient; furthermore, it eliminates the need of proving that the defendant had access to information possessed by others in the issuer's management. See text following note 76 infra. The only qualification in such cases is that the information must in some sense be "inside" information, or information which the defendant receives because of his relationship with the issuer. See note 91 infra and accompanying text.

65. Abuse would be impossible because inside information could not have motivated the defendant's initial sale or purchase. However, the inquiry should not be phrased in terms of the defendant's motivation, but merely in terms of foreseeability. The defendant should not be allowed to avoid liability by showing plausible, innocent reasons for trading as he did. The Supreme Court at least suggested the propriety of such considerations in Kern County by observing:

Occidental wanted to avoid the position of a minority stockholder with a huge investment in a company over which it had no control and in which it had not chosen to invest. On the other hand, Tenneco did not want a potentially troublesome minority shareholder that had just been vanquished in a fight for the control of Old Kern. Motivations like these do not smack of insider trading ... . . . . 411 U.S. at 601. This reasoning was used to support the Court's conclusion that an option agreement between Tenneco and Occidental was not a section 16(b) 'sale.' See note 16 supra, Contra, Newmark v. RKO General, Inc., 425 F.2d 348, 353 (2d Cir.), cert. denied,
quiry must focus on the actual cause of the price change. While foreseeability is easily assessed if the change is due to one specific event, such as the announcement of a merger or the declaration of unusually large dividends, more difficult cases will arise where a price change is due to a variety of uncertain causes. Such cases may pose theoretical dilemmas, but they should present few practical problems, for even differences between the buying and the selling price that are not caused by identifiable, specific events may often be easily explained. The difference may, for instance, be due to an over-all rise or fall in the stock market, or to the fact that the insider's purchase was a small block of shares and his sale includes his entire holdings. Even if the causes cannot be isolated, practical difficulties may be further resolved by placing the burden of proof on the defendant. He can show (1) that no rational explanation for the price differential exists, in which case he could not have relied on relevant inside information when making his initial transaction; or (2) that the total differential is the product of a specific event that could not have been foreseen at the time he began his short-swing.

Once it is established that the cause of at least part of the defendant's profits could have been the subject of inside information, the court should turn to the question of whether the public at large had access to the information.

400 U.S. 854 (1970): "That RKO's heart may have been pure and its motivation noble matters not." To allow such a showing of motives might conflict with the explicit statutory command not to consider the insider's intent to hold or to refrain from repurchasing his securities for six months. See note 50 supra. Even if the statute's terms are not conclusive, they do indicate reluctance to permit unreliable inquiries into an investor's mental state.

65. This type of inquiry is already made in some cases using the pragmatic approach. See, e.g., Newmark v. RKO General, Inc., 425 F.2d 348, 353 (2d Cir.), cert. denied, 400 U.S. 854 (1970):

RKO had full knowledge of the proposed merger at the time it signed this contract. Release thereafter of the proposed merger agreement to the public caused a predictable rise in the price of the securities of both airlines. RKO was in an ideal position to take speculative advantage of this rise by purchasing Central securities at a price established in the purchase agreement and disposing of these securities after disclosure had caused them to increase in value.

(Emphasis added).


68. More precisely, the defendant must show that the price differential was entirely unexplainable or unforeseeable. If even part of it was the product of a foreseeable cause the possibility of abuse cannot be completely excluded.

69. Cf. note 68 supra.

70. The burden of proof logically rests on the defendant because the plaintiff establishes a prima facie case under section 16(b) simply by showing that an insider has made a purchase and sale or sale and purchase within six months. The defendant, in other words, is trying to escape liability under a statute that is applicable to him on its face.
Trading by officers, directors, and beneficial owners is regulated under section 16(b) because of the possibility that insiders may be using secret information to gain an unfair trading advantage. 71 However, if any relevant information that an insider may have prior to beginning his short-swing is shared by the investing public, there is no "possibility of abuse." 72 The defendant should be allowed to demonstrate public access to the relevant information by proving (1) that it is the sort of information that by its nature is generally available to the public, or (2) that it was adequately disclosed. The general availability of the information that an attempted corporate takeover may result in a defensive merger by the target corporation was emphasized by the Supreme Court in Kern County:

Perhaps Occidental anticipated that extending its offer would increase the likelihood of the . . . occurrence of a defensive merger. But again, the expectation of such benefits [that is, the higher prices resulting from the merger] was unrelated to the use of information unavailable to other stockholders or members of the public with sufficient funds and the intention to make the purchases Occidental had offered to make . . . . 73

In Adler v. Klawans, 74 the court stressed the fact that the relevant information—that a distribution of dividends was forthcoming—had been disclosed before the defendant became an insider: "At the time of [defendant's] purchase it can reasonably be assumed that the forthcoming dividend was a matter of public knowledge. [Defendant]"

71. See text accompanying note 28 supra.

[T]he Rule is based in policy on the justifiable expectation of the securities marketplace that all investors trading on impersonal exchanges have relatively equal access to material information . . . .

. . . . The only regulatory objective is that access to material information be enjoyed equally, but this objective requires nothing more than the disclosure of basic facts so that outsiders may draw upon their own evaluative expertise in reaching their own investment decisions with knowledge equal to that of the insiders.

73. 411 U.S. 582, 598 (1973). Another instance in which a profit is inherently foreseeable by the public as well as by insiders is a sale-of-control situation. A controlling shareholder may buy 100 shares at one price and sell the same shares for a higher price within six months if the sale includes all of his holdings. The higher price may, in effect, be a premium for relinquishing control. The insider's information that this profit could be made would hardly be characterized as "secret." Similarly, news of an increase in military spending might prompt an officer of an arms manufacturing corporation to purchase his issuer's stock, but if the news was publicly distributed the officer should not face section 16(b) liability if the increased spending makes his stock more valuable. See Roberts v. Eaton, 212 F.2d 82, 85 (2d Cir.), cert. denied, 348 U.S. 827 (1954): "[A]ny change in value due to the split or reclassification of stock comes substantially from the actual or expected tastes and preferences of the public for particular types and forms of securities . . . . [A]s to this type of market bonus, the insider has no more knowledge than the rest of the world, and is not benefiting by the fruits of inside speculation."

74. 267 F.2d 840 (2d Cir. 1959).
was in no different position with respect to this dividend from that of any other member of the stock buying public. 76

The defendant should prevail only where the public's informational resources are fully equal to his own. A profitable price change may be foreseeable to both the public and the insider, but there is still a "possibility of abuse" if the differential is seen as only a remote possibility by the public but is seen as a virtual certainty by the insider. Therefore, the insider must take pains to ensure that any disclosure represents "the whole truth" and must refrain from trading until outsiders are allowed a reasonable time to absorb the information. 75

Even where the public had no way of knowing of the relevant information, there would be no possibility of abuse unless the particular defendant had access to it. The issue then becomes what kind of proof by the defendant should be sufficient to establish that he had no access. On first glance, it may appear that access can be conclusively presumed from the fact that a defendant was an insider prior to his initial transaction. However, Kern County 77 and Gold v. Sloan 78 indicate that, when defendants are insiders but not part of the controlling management of their respective issuers, access cannot be conclusively presumed. In Kern County, for example, the defendant-offeror was technically an insider with respect to the target corporation before it made an extension of its tender offer, but the target's

75. 267 F.2d at 848. See also Newmark v. RKO General, Inc., 425 F.2d 848, 854 (2d Cir.), cert. denied, 400 U.S. 854 (1970); "RKO's success in fixing the purchase price before the proposed merger became public knowledge opened the door to possible speculative gains" (emphasis added), but see Gold v. Sloan, 486 F.2d 340 (4th Cir. 1973), discussed in notes 26 & 62 supra. Gold must be regarded as an anomaly because, although it did not even discuss the disclosure issue with respect to defendant Sloan (who conducted the merger negotiations), it noted with respect to defendant Scurlock (a dissident director not involved in the merger negotiations) that:

[A] proxy statement had been prepared in connection with the merger. That proxy statement gave complete information both on Susquehanna as it existed before the merger and as it was expected to be after the merger. This was available to all stockholders of the old ARC as well as to all stockholders of Susquehanna. After all, it is the unfair use of inside information against which the statute is directed and plainly where there has been full disclosure, as is given by a proxy statement, the potential for unfairness and any basis for invoking the statute disappears.

486 F.2d at 340. Why the same disclosure did not exonerate all the defendants is not explained. The incorporation of a disclosure element into the pragmatic test in Newmark is criticized in Casenote, 84 Harv. L. Rev. 1012, 1018-19 (1971). The commentator argues that RKO only bought shares from those who knew about the proposed merger, making public disclosure superfluous. This ignores the fact that section 16(b) does not seek only to equalize information between a purchasing insider and those from whom he buys; the broader purpose is to prevent the insider from making profits on the basis of information unavailable to others. This purpose is served by regulating insider trading whether or not those who trade with the insider are being duped.


77. A summary of the facts and holding of Kern County is set out in note 16 supra.

management was hostile and very unlikely to provide the defendant with inside information about the defensive merger that increased the value of defendant's stock. The Court found that the defendant had no access to inside information and that, therefore, there was no possibility of abuse. Similarly, in Gold one defendant-director was exonerated because "[H]e was simply a disaffected stockholder and powerless director, tolerated but not welcomed by the management. . . . [H]e was as removed from the actual [merger] negotiations between [the issuer and another corporation] and was as much of an outsider looking on as was Occidental in Kern County." Two other officers were found not to have made section 16(b) purchases: "Both . . . were in the lower management hierarchy. Neither had the slightest connections with the merger negotiations . . . and [they] were as ignorant of merger developments as any outside shareholder."

However, Kern County and Gold are highly questionable interpretations of the statute. The legislative history of section 16(b) reveals no intention to separate the inquiry into access from the question of insider status. Indeed, the hearings on the definition of an "insider" emphasize Congress' concern that those placed in the "insider" category normally be endowed with access to corporate information. The congressional determination as to which investors have access and which do not is embodied in the definition of "insider" and should be respected. Moreover, all insiders, including those within noncontrolling groups, may enjoy some advantages over the

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79. 411 U.S. at 598-99.
80. 486 F.2d at 344, 346.
81. 486 F.2d at 351.

Gold may be read as requiring not only access to, but actual possession of, insider knowledge that could have encouraged speculation. The court stresses that defendant "Scurlock possessed no knowledge that might have helped him speculate in Susquehanna's stock." 486 F.2d at 346 (emphasis added). It adds that "the only relevant distinction to be made between Sloan and the other defendants in this case is that Sloan possessed specific financial information . . . that would have helped him to predict the future performance of Susquehanna stock . . . ." 486 F.2d at 352 (emphasis added). The court concludes that "[t]he actual knowledge possessed by an insider at the time of a given 'unorthodox transaction' is an essential element to be considered in determining whether a 16(b) 'purchase' has occurred." 486 F.2d at 352-53. It must be remembered, however, that the court in Gold was making a conscious effort to adhere to the doctrine set forth by the Supreme Court in Kern County: "[The issue is . . . whether the defendant 'had or was likely to have access to insider information, . . . so as to afford it [or him] an opportunity to reap speculative, short-swing profits.']" 486 F.2d at 349-44, quoting 411 U.S. at 596 (emphasis added). The Court in Kern County definitely did not adopt a test based on actual possession of advance knowledge; it based its holding on the hostile relationship between Occidental and Old Kern, which precluded the possibility of an information swap. See note 16 supra and accompanying text. Perhaps the language in Gold was simply inadvertent overstatement; taken seriously, it represents a misreading of the Supreme Court's approach in Kern County and a departure from established doctrine. See Blau v. Max Factor & Co., 342 F.2d 304, 307 n.6 (9th Cir.), cert. denied, 382 U.S. 892 (1965).

82. See Senate Hearings, supra note 41, pt. 16, at 7141-42.
ordinary shareholders. They are, at the very least, closer to corporate decision-making and more likely to have advance information even about policies they oppose.\textsuperscript{83} If the approach taken in \textit{Gold} and \textit{Kern County} is followed by other courts, section 16(b) should at least be held to raise a strong presumption that insiders have access to advance information.\textsuperscript{84} Perhaps rebuttal of the presumption should be allowed only where the defendant can establish that he was regularly excluded from access to the type of information at issue. Evidence that the defendant had no access to the particular information involved in the lawsuit is likely to be less reliable and more difficult for the plaintiff to disprove.

Proof that the defendant, although an insider, did not have the typical insider's access to information should be sufficient to rule out possibility of abuse only in rare circumstances. However, proof that the defendant was not an insider at all prior to his initial transaction should be accepted more readily, for the presumption of access arising from the fact of insider status would then be irrelevant. In the case of those who later become officers and directors, however, access to relevant information may exist even before insider status is achieved.

Assume that investor Queen purchased shares in Chess Corporation on January 5. On March 5, she was placed on the Chess board, and on April 5, she sells the shares at a profit. The prevailing judicial view is that Queen would be held accountable under section 16(b), although she was not an insider when she purchased.\textsuperscript{85} This result is often justified in terms of single-transaction abuse: Even though Queen's purchase may have been innocent, her sale could have been influenced by inside information.\textsuperscript{86} But single-transaction abuse

\textsuperscript{83} Even in \textit{Kern County}, where Occidental was not on friendly terms with those in control of Old Kern, see note 16 supra, the Court noted that Occidental was afforded access to Old Kern's general ledger, consolidated financial statements, consolidated journal entries, details of cash receipts from oil operations, supporting trial balances, and other records. 411 U.S. at 587 n.12.


\begin{quote}
"We start from the statutory presumption, emphasized in Chemical Fund, Inc. v. Xerox Corporation, 377 F.2d 107, 110 (2d Cir. 1967), that \"... section 16 is specifically concerned with \'directors, officers and principal stockholders,\' and has adopted a rule that any stockholder owning more than 10 per cent of an equity security is presumed to be an insider who will receive information regarding the company before it is made public.\""
\end{quote}

Of course, the rule states only a [rebuttable] presumption . . . .


\textsuperscript{86} See Blau v. Allen, 163 F. Supp. 702, 704 (S.D.N.Y. 1958): \"[A] purchaser of stock need not have access to insider information in entering into his initial transaction. Having become an insider by virtue of having become a director, it [is the] defendant's subsequent speculation that is the \'vice within the purview of \$ 16(b).\'\" (Emphasis added). See also Gold v. Sloan, 486 F.2d 340, 357 (4th Cir. 1973) (Winter, J., dissenting in part); note 38 supra and accompanying text.
should be outside the scope of the section 16(b) prohibition.\textsuperscript{87} If Queen is to be held accountable, it should not be in spite of what was presumably an innocent purchase, but because the fact that she was not an insider at the time does not necessarily mean that her purchase was in fact innocent. Suppose, for instance, that Queen's profits resulted from a price rise caused by an announcement on March 15 of huge Chess dividends, which Queen had voted for and strenuously advocated. There is at least the possibility that, on January 5, Queen knew that she would become a director and that she would soon be able to sponsor an action, such as the declaration of high dividends, that would allow her to reap short-swing profits.\textsuperscript{88} Such manipulation clearly falls within the bounds of double-transaction abuse; Queen had access to the relevant information on January 5 because it concerned action that she herself would initiate.\textsuperscript{89} This hypothetical case

\textsuperscript{87} See text accompanying notes 41-61 supra.

\textsuperscript{88} See, e.g., Adler v. Klawans, 267 F.2d 840 (2d Cir. 1959), Defendant purchased stock of Williams-McWilliams Industries, Inc., at various times between October 1, 1956, and January 17, 1957. He became a director on March 16, 1957, and by May 3, 1957, he had completely divested himself of his issuer's stock. "From the outset of his term as director, commencing with the first meeting he attended—on the day he was elected—he was active in pressing for the payment of dividends both in cash and in stock." 267 F.2d at 844. Furthermore, he moved a resolution that the corporation purchase a substantial amount of its own stock, which, of course, would help support the market for the disposal of his own stock at a profit. 267 F.2d at 845-46.

\textsuperscript{89} Cf. Smolowe v. Delendo Corp., 136 F.2d 231, 236 (2d Cir.), cert. denied, 320 U.S. 751 (1944): "It is naive to suppose that their knowledge of their own plans as officers did not give them most valuable inside knowledge as to what would probably happen to the stock in which they were dealing."

Many courts that have invoked the "possibility of abuse" test have relied heavily on factors of "control" and "voluntariness" in judging whether a defendant has made a purchase or sale. E.g., Kern County Land Co. v. Occidental Petroleum Corp., 411 U.S. 582, 599 (1973): The critical fact is that the exchange took place and was required pursuant to a merger between Old Kern and Tenneco. That merger was not engineered by Occidental but was sought by Old Kern to frustrate the attempts of Occidental to gain control of Old Kern. Occidental obviously did not participate in or control the negotiations or the agreement between Old Kern and Tenneco.


The "control" factor must be placed in proper perspective—it is not important of itself but only as it bears on the defendant's access to information. See Blau v. Lamb, 363 F.2d 507, 511 n.19 (2d Cir. 1966), cert. denied, 385 U.S. 1002 (1967):

Even a noncontrolling "insider" has the power to misuse inside information for speculative purposes by trading in light of the inside information to which he is privy. A "controlling insider" also can manipulate corporate activity in order to create favorable short-swing trading situations. But certain types of transactions may not present any opportunity for the exercise of either "noncontrolling" or "controlling" insider power to misuse inside information.

Where the defendant was not an insider prior to his initial transaction, a finding that he controlled the event that caused his profits could be decisive in showing a possibility of abuse, because it would establish the defendant's access to advance information about the price change in spite of his lack of insider status. Such a finding would not be vital to plaintiff's case where the defendant was an insider all along—
indicates that, although it seems reasonable to presume a lack of access from a lack of insider status, the presumption should not be conclusive. In order to rebut the presumption, however, the plaintiff should be required to demonstrate not only that the defendant could have had access to the information, but also that access came to him by virtue of his potential insider status, for the statute aims to deter the abuse of only that information that the investor acquires “by reason of his relationship to the issuer.”

Similar problems exist with regard to investors who, prior to their initial transaction, owned ten per cent or less of the issuer's stock and thus were not insiders. Section 16(b) provides, however, that “[i]t is control over the price change that is important; whether the defendant's transaction was voluntary or involuntary should make no difference since that does not bear on the question of access to inside information. Cf. Park & Tilford, Inc. v. Schulte, 160 F.2d 994, 997-98 (2d Cir.), cert. denied, 332 U.S. 761 (1947).

90. Champion Home Builders Co. v. Jeffress, No. 73-1341 (6th Cir. Jan. 11, 1974) (excerpted in 42 U.S.L.W. 2397), revg. 352 F. Supp. 1081 (E.D. Mich. 1973), illustrates another situation where lack of access should not be conclusively presumed from lack of insider status. Defendant Jeffress, the sole owner of Concord Mobile Homes, Inc. (Concord), entered into an agreement with Champion Home Builders Co. (Champion) whereby he would exchange all of his Concord stock in return for 13 per cent of Champion's outstanding shares. The exchange made Jeffress a Champion insider; furthermore, Jeffress became an officer and director of Champion after the exchange. Suit was brought against Jeffress under section 16(b) after he sold some of his Champion stock at a profit within six months of the exchange. Ordinarily it might be assumed that no double-transaction abuse is possible in such situation; since Jeffress was not an insider prior to his purchase he presumably did not know of the price rise in Champion stock that was soon to take place. The court correctly observed, however, that Champion and Jeffress were on close terms before the purchase and that Jeffress “knew that the two companies was [sic] going to make the price go up, or at least this is what [he] thought would happen.” No. 73-1341, slip op. at 10. Furthermore, Jeffress had participated in meetings of the Champion board even before he became an insider, 352 F. Supp. at 1083-84, and he had had advance knowledge of the stock-split that occurred shortly after his purchase and that helped to create a rising market for his shares. No. 73-1341, slip op. at 10-11. Even if Jeffress did not create the price rise himself, therefore, his close relationship with the issuer prior to his purchase justified a finding that he had access to inside information, in spite of his lack of technical insider status.

91. The courts should not interpret this requirement too strictly. Consider, for example, Champion Home Builders Co. v. Jeffress, No. 73-1341 (6th Cir. Jan. 11, 1974) (excerpted in 42 U.S.L.W. 2397), discussed in note 90 supra. The defendant received the relevant inside information before he was technically an insider; arguably his purchase breached no fiduciary duty to Champion, and he should not have been held liable because the information was not acquired “by reason of his relationship to the issuer.” See Comment, Short-Swing Profits and the Ten Per Cent Rule, 9 STAN. L. REV. 582, 585-88 (1957). Surely, however, Jeffress would not have received information but for the fact that he was soon to become an insider. Furthermore, it was his close bargaining “relationship with the issuer” that allowed him access to the information. In such situations, the purposes of the statute are better served by imposing liability, even if this must be done through a fiction of “relation back” or “constructive” insider status.
and sale, or the sale and purchase, of the security involved . . . ." 92
Since the exemption does not refer to officers and directors it raises a
strong negative implication that initial transactions by officers and
directors are not automatically excluded from the reach of the statute
simply because they were not insiders until after their first trans-
action.93 The justification for treating officers and directors differently
than shareholders of over ten per cent was explained in Adler v.
Klawans,94 which held a director liable for purchases made before he
assumed his position:

Generally, although there are important exceptions in certain cir-
cumstances, officers and directors have more ready access to the inti-
mate business secrets of corporations and factors which can affect the
real and ultimately the market value of stock than does even so large
a stockholder as a “10% beneficial owner.” . . . Moreover, a director
or officer can usually stimulate more directly actions which affect
stock values and have knowledge of factors which might depress
values . . . Beyond doubt it was considerations of this character
which led Congress to make a provision concerning 10% owners
which was not made with respect to officers and directors.95

The statute clearly indicates that proof that a defendant was not
an owner of over ten per cent of the stock either before or after a
transaction should remove that transaction from the reach of the
statute. However, it leaves unclear whether the transaction that
brings a defendant’s holdings to over ten per cent should fall within
the exemption.96 Assume that an investor purchases nine per cent
of a corporation’s stock on January 5 and another two per cent on
January 10. He sells the entire eleven per cent within six months.
The statute clearly exempts the January 5 purchase, for the investor
was not a beneficial owner of more than ten per cent “at the time of”
that transaction. The prevailing view is that section 16(b) does em-
brace the January 10 transaction, which put the investor over the ten
per cent line.97 This view would liberally construe the statutory

93. Adler v. Klawans, 267 F.2d 840 (2d Cir. 1959). The court relied heavily on the
statutory proviso for beneficial owners of over ten per cent in reaching its conclusion:
“Under the familiar canon of construction, expressio unius est exclusio alterius [“to
include one is to exclude the other”], the presence of this emphatic and unmistakable
clause in the portion governing the one class demonstrates a clear legislative intent that
no such provision applies to the other.” 267 F.2d at 845.
94. 267 F.2d 840 (2d Cir. 1959).
95. 267 F.2d at 842.
96. See Emerson Elec. Co. v. Reliance Elec. Co., 434 F.2d 918, 923 (8th Cir. 1970),
affd. on other grounds, 404 U.S. 418 (1972).
affd. on other grounds, 404 U.S. 418 (1972); Stella v. Graham-Paige Motors Corp., 104
F. Supp. 967 (S.D.N.Y. 1952); Newmark v. RKO General, Inc. 425 F.2d 348 (2d Cir.),
language, "at the time of [the purchase]" to mean "simultaneous with" or "immediately after," rather than "immediately prior to." Thus, section 16(b) would cover the January 10 purchase because the defendant became an eleven per cent beneficial owner "simultaneous with" his purchase.

This result has been justified on the grounds of the possibility of single-transaction abuse. As in the case of officers and directors, this rationale is insufficient. A justification in terms of possible double-transaction abuse also appears inadequate. It may be argued, as it was with regard to directors and officers, that, even where the investor is not an insider before his initial transaction, an opportunity for manipulation is present if he becomes an insider later; thus, the investor who becomes a large stockholder can misuse his position in such a way that he will be able to reap profits even from the transaction that first made him an insider. Such manipulation would in fact be double-transaction abuse. The investor would have had access to relevant information when he made his initial transaction, because he himself planned to cause the price change that would lead to his subsequent profits. To return to the investor who makes a nine per cent purchase, followed by a two per cent purchase, followed within six months by a sale of the entire eleven per cent, it could be argued that the exemption was designed to exclude liability for the nine per cent purchase, because such a purchase would not, in itself, give the investor the ten per cent plus ownership that presumably indicates power to manipulate. The two per cent purchase would be within the reach of the statute, however, because it would create insider status and the power to manipulate. On its surface, this argument seems consistent with the statute's clear exemption of the nine per cent purchase and with the exemption's function of ensuring that liability is imposed only on those investors who have the power to manipulate. The fallacy of the argument can be shown in its distinction between the nine per cent purchase and the two per cent purchase. The exclusion of the nine per cent purchase cannot


99. See text accompanying notes 86-87 supra.

100. See notes 88-89 supra and accompanying text.


Illustrative of some of the mischief that would be permitted in spite of Congress' action in enacting 16(b) [if there were no liability for the very transaction that makes one an insider] is an initial purchase of as large a block of stock as 51 percent or more of a corporation's stock, followed by a sale anytime within six months by the stockholder who obviously within that period could obtain much inside information and also could influence, manipulate or control corporate transactions.

(Emphasis added).

102. See text accompanying note 95 supra.
be justified on the grounds that it is not followed by insider status and power to manipulate. The investor could be planning to buy more stock and manipulate the price as easily at this early stage as later. Indeed, where the investor actually makes the subsequent purchases that bring him insider status—the only situation to which the exemption applies, since otherwise the investor's purchases are clearly not covered by the statute—there is a possibility that an intent to manipulate actually existed at the time of the nine per cent purchase. In this situation, therefore, the reason that the nine per cent purchase is exempt is not because it is not followed by the power to manipulate. Rather, it is exempt in spite of the fact that it is followed by the power to manipulate. Since any power to manipulate that might arise from the two per cent purchase could also have motivated the nine per cent purchase, there is no reason to exempt the latter, as the statutory provision does, without exempting the former as well. At the root of the statutory exemption, in other words, is the determination that even investors who are about to acquire more than ten per cent of their issuer's stock do not have the degree of power to manipulate possessed by investors on the verge of becoming officers and directors.103 Recovery should, therefore, be restricted to profits made from two transactions that are both initiated after the investor becomes an owner of over ten per cent, when he has full access to all corporate information, rather than just access to information about price changes flowing from his own future power to manipulate.104

Even if courts continue to impose liability on transactions that make the investor an owner of over ten per cent of the issuer's stock, such liability should not be imposed automatically. Because of the limited kind of access available to a defendant who has not been an insider in the past, this liberal interpretation should, at most, allow the introduction of evidence that the defendant in fact had access to inside information prior to his purchase.

No matter how the proviso is interpreted, however, evidence should be allowed that would establish that the investor's purchase has merely restored him to insider status.105 In this way, the exempt-

103. This conclusion agrees with the judicial explanation of the dichotomy in the statutory exemption. See text accompanying note 95 supra.

104. Most of the commentary is in agreement. See, e.g., W. Painter, supra note 30, at 40-42; Munier, supra note 52, at 74-75; Comment, 9 Stan. L. Rev. 552, supra note 91, at 586-88; Comment, 117 U. Pa. L. Rev. 1054, supra note 3, at 1041 n.39; Casenote, 72 Colum. L. Rev. 1090, supra note 52, at 1101; Casenote, 70 Harv. L. Rev. 1312, supra note 52, at 1313, Contra, 2 L. Loss, supra note 6, at 1061; Cook & Feldman, Insider Trading Under the Securities Exchange Act (pt. 2), 66 Harv. L. Rev. 612, 631-32 (1953).

105. The "at the time of" language in the proviso could be construed as meaning "prior to" in all cases except those involving a repurchase, where the construction would be "simultaneous with." Emerson Elec. Co. v. Reliance Elec. Co., 434 F.2d 518, 522-23 (8th Cir. 1970), affd. on other grounds, 404 U.S. 418 (1972) (dictum). See Comment, 9 Stan. L. Rev. 552, supra note 91, at 588 n.38; Casenote, 70 Harv. L. Rev. 1312, supra note 52, at 1313.
tion would not allow an investor "to purchase a large block of stock, sell it out until his ownership [is] reduced to less than 10%, and then repeat the process, ad infinitum." 106

The inquiries described above can be separated, so that the "possibility of abuse" test takes two forms. In a limited sense, it would inquire only whether a given unorthodox transaction destroys the defendant's continuity of investment. A broader interpretation of the test would include an examination of the cause of the price change that led to the defendant's profits, the public's access to the relevant information, and the access of the particular defendant. The dichotomy between a broad and a narrow interpretation of "possibility of abuse" is not merely theoretical. The early cases among those that have been grouped together under the broad rubric of the "possibility of abuse" approach addressed only the task of defining "purchase" and "sale" and limited their inquiry to continuity of investment. Later cases expanded both the use to which the test was put and the scope of the inquiry. Finally, the Supreme Court, in Kern County, adopted the questionable approach of applying a broad "possibility of abuse" test to the narrow purpose of defining "purchase" and "sale." 107

The approach of the Sixth Circuit in Ferraiolo v. Newman 108 illustrates the first stage in this development. The question before the court was whether a director's conversion of preferred stock into common stock under threat of a redemption call was a "purchase" under section 16(b). Although the court noted that the defendant appeared to be "a very inactive director" 109 and that "he was not in fact privy to any inside information concerning the company," 110 it said that "[s]uch considerations . . . are entirely irrelevant to the applicability of section 16(b)." 111 Instead, the court rested its holding that the conversion was not a "purchase" on the fact that "[o]nce the market price of the common stock rose above the redemption price of the preferred, the preferred, with its undilutable conversion privilege, became, in the objective judgment of the market place, the economic equivalent of the common." 112 Ferraiolo was typical of the early cases 113 that endorsed the pragmatic approach in that it decided

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107. See text accompanying note 125 infra.
109. 259 F.2d at 344.
110. 259 F.2d at 344.
112. 259 F.2d at 345.
113. See, e.g., Petteys v. Butler, 367 F.2d 528 (8th Cir. 1966), cert. denied, 385 U.S. 1006 (1967); Blau v. Lamb, 363 F.2d 507 (2d Cir. 1966), cert. denied, 385 U.S. 1002 (1967);
the "purchase" and "sale" issue on the narrow ground of continuity of investment but used broader language that spoke of a possibility of abuse: "Every transaction which can reasonably be defined as a purchase will be so defined, if the transaction is of a kind which can possibly lend itself to the speculation encompassed by Section 16(b)." Even this language focuses on the "kind" of the particular transaction, rather than on broader questions, such as access. The court's broad language, however, provided a handle for the extension of the pragmatic approach in later cases.

In Blau v. Lamb, a 1966 decision by the Second Circuit, the language used by the court went far beyond Ferraiolo, although the decision was based on the same narrow ground. As in Ferraiolo, the court decided that a conversion of preferred stock into common stock was not within the terms of section 16(b) because the common stock was the "economic equivalent" of the preferred. The court justified its use of the pragmatic approach by stating that the "underlying purpose [of the statute] provides no reason for the application of Section 16(b) to a transaction that poses no danger whatever of insider abuse." The rule expressed in Blau v. Lamb, in other words, was cessante ratione legis, cessat et ipsa lex ("the reason of the law ceasing, the law itself also ceases").

The first important extension of the pragmatic approach that went beyond mere language was made by the Second Circuit in Newmark v. RKO General, Inc., where the court not only looked at noneconomic factors, but also used the "possibility of abuse" test to decide a more fundamental issue than whether a given transaction was a "purchase" or "sale." The case involved a purchase and subsequent exchange of shares pursuant to merger. The court ad-


116. 365 F.2d at 521-23.

117. 365 F.2d at 519.

118. 365 F.2d at 519.


120. Newmark was one of the first appellate court cases to apply the pragmatic approach to an exchange of shares pursuant to a merger. Earlier unorthodox transaction cases dealt almost exclusively with stock conversions and reclassifications. The conversion problem was largely eliminated in 1966, when the SEC promulgated rule 16b-9, 17 C.F.R. § 240.16b-9 (1975), exempting most conversions from the reach of the section. Recent cases, perhaps for this reason, have centered around the merger-exchange problem. See, e.g., Kern County Land Co. v. Occidental Petroleum Corp., 411 U.S. 582 (1975); Gold v. Sloan, 486 F.2d 540 (4th Cir. 1973); American Standard, Inc. v. Crane Co., 346 F. Supp. 1155 (S.D.N.Y. 1971). The change in the type of "unorthodox" transactions to be brought before the appellate courts has no doubt contributed to the expansion of
dressed itself first to what it termed the “threshold issue” of whether the defendant’s transactions lent themselves to “the type of speculative abuse which section 16(b) was designed to prevent.” In dealing with this issue the court focused on the fact that the defendant purchased the shares in question before news of the merger had been publicly disclosed rather than on the break in the continuity of investment represented by the merger exchange. Significantly, the court discussed the issue of whether the merger exchange was a “sale” separately and only after it had decided that the two transactions indicated a possibility of abuse. The definitional point was then quickly settled by noting that, since the defendant had acquired the securities of a different company, the “economic equivalence” doctrine did not apply. Newmark, in other words, did not use “possibility of abuse” as a touchstone for defining “purchase” and “sale,” but as a general indicator of when it is just to apply the statute and when it is not.

After Newmark, the courts continued to expand their inquiry into the noneconomic aspects of the pragmatic approach. For instance, Kern County and Gold v. Sloan both found that there was no possibility of abuse where the defendant was a noncontrolling insider who had no access to inside information. Kern County, however, applied Newmark’s broad “possibility of abuse” test not as a threshold inquiry but as a touchstone for deciding the more narrow issue of whether a given transaction is a “purchase” or “sale.” In so doing, the Court limited the use of the “possibility of abuse” test to cases where the existence of a “purchase” or a “sale” is at issue—that is, to cases of “unorthodox transactions.” In other words, the Court’s decision did not go as far as Newmark in that it refused to look into “possibility of abuse” as a “threshold issue,” but went beyond Newmark in that it considered the particular defendant’s access to the relevant corporate information.

The “possibility of abuse” test, in the broad sense in which Kern County used it, is inappropriate for the purpose of defining whether a transaction is a “purchase” or “sale.” The Kern County approach

the pragmatic approach to include such inquiries as the existence of access to information, because cases involving conversions could easily be disposed of on “continuity of investment” grounds. Cases involving merger exchanges, however, could not be decided on this ground; broader inquiries were therefore developed to deal with those cases in which courts did not want to impose liability.

121. 425 F.2d at 353.
122. 425 F.2d at 354.
124. See text accompanying note 79 supra (Kern County); text accompanying notes 80-81 supra (Gold).
125. 411 U.S. at 593-95.
creates a completely arbitrary distinction between “orthodox” and “unorthodox” transactions. The investor who trades on a strict stock-for-cash basis faces section 16(b) liability irrespective of “possibility of abuse”: “It is true enough that, in the case of a garden-variety purchase and sale or sale and purchase within six months . . . it would be no defense that a person within its terms was operating, by sheer intuition, from Antarctica or even from outer space.”126 If the same individual options away his shares, however, he has made an “unorthodox transaction,” and the courts will consider such matters as disclosure and his lack of access to inside information. If the defendant is to be relieved of liability because he could not have abused his insider status, he should be relieved whether he has traded his securities for other securities pursuant to a merger or simply sold them for cash.

This dichotomy between orthodox and unorthodox transactions is also irrational because such matters as disclosure and lack of access are completely unrelated to the economic function of the defendant’s transactions. The only relevant distinction between orthodox and unorthodox transactions as “purchases” or “sales” lies in the discontinuity of investment that always characterizes the former and may or may not characterize the latter.127 The illogic of introducing other considerations is illustrated by Gold v. Sloan, one of the first of the progeny of Kern County. Gold refused to hold two officers of the Susquehanna Corporation liable under section 16(b) even though they obtained Susquehanna shares pursuant to a merger exchange and sold them for cash within six months. The court specifically based its finding that the two officers had not made “purchases” under the statute on the fact that “[b]oth [officers] were in the lower management hierarchy. Neither had the slightest connection with the merger negotiations . . . and [both] were as ignorant of merger developments as any outside stockholder.”128 Furthermore, the court found that the status of one of the defendants as an officer was “merely titular”; another insider who had conducted exactly the same transactions but who was more involved in the affairs of the corporation was found


127. The idea that unorthodox transactions are perhaps more likely to be “involuntary” can hardly justify the preferential treatment of those who make them. Not only are many unorthodox transactions voluntary (the grant of an option, for example), but involuntary stock-for-cash trades may easily be imagined. Cf. Western Auto Supply Co. v. Gamble-Skogmo, Inc., 348 F.2d 736, 742 (8th Cir. 1965), cert. denied, 382 U.S. 97 (1965) (defendant claimed sale was motivated by pendency of antitrust litigation). See also note 29 supra.

128. 486 F.2d at 351.
to have made a "purchase." This logical inconsistency could be resolved by treating all the investors as having made purchases, but exempting the "ignorant" directors and officers because their trading was innocent in light of the broad possibility of abuse test.

If the test for determining whether a transaction is a "purchase" or "sale" is limited to an examination of continuity of investment, the question remains: Is there a role to be played by the broader "possibility of abuse" test? It could be argued that in the light of the objective, all-encompassing language of section 16(b) the only function for the pragmatic approach is as a tool of statutory construction in ambiguous cases. When all elements of the statute are satisfied, as they are where all transactions are "purchases" or "sales" under the "continuity of investment" standard, liability must automatically ensue. This argument has force, but it is not decisive. Although the statutory language is broad enough to reach all situations where abuse is possible, there is no reason to extend it to cover any

129. 486 F.2d at 351-53.

130. Another illustration of the analytical difficulties presented by the Kern County approach is found in the two opinions of Judge Lasker in American Standard, Inc. v. Crane Co., 346 F. Supp. 1153 (S.D.N.Y. 1971), 346 F. Supp. at 1165 (Supp. Op. 1972). Crane Co. had purchased 32 per cent of the stock of Air Brake Co. by the end of May 1968. Crane exchanged its Air Brake stock for American Standard stock between June 7 and June 13, 1968, pursuant to a merger between Air Brake and American Standard. Finally, on June 13, 1968, and shortly thereafter, Crane sold its American Standard stock for cash on the open market. Suit was brought under section 16(b), alleging that Crane had "sold" its Air Brake stock when it exchanged it for American Standard stock. The court granted the plaintiff summary judgment in its 1971 opinion, following the Newmark analysis by discussing "opportunities for speculative abuse" as a threshold inquiry independent of its decision that Crane's exchange was a 16(b) "sale." Furthermore, after deciding there was a possibility of abuse, the court decided the "sale" issue simply by citing Newmark and Blau v. Lamb to the effect that the exchange of securities of one company for the securities of a different company does not satisfy the "economic equivalence" doctrine. 346 F. Supp. at 1161.

On the day after the court's opinion was issued, the Second Circuit decided Abrams v. Occidental Petroleum Corp., 450 F.2d 157 (1971), affd. sub nom. Kern County Land Co. v. Occidental Petroleum Corp., 411 U.S. 582 (1973), using the approach that was later adopted by the Supreme Court in Kern County. Judge Lasker withdrew his opinion to permit consideration of the impact of Abrams on the American Standard litigation. Interestingly, Judge Lasker also decided for plaintiff in his supplemental opinion, but the reasoning was tortured because of a justifiable effort to fit the earlier holding into the Abrams framework. The Abrams rationale, in the context of the factual similarity of the Abrams and the American Standard situations, forced the court to realize that its finding of a possibility of abuse might well be open to question. Thus, according to Abrams, the merger exchange was not a sale. But, the court concluded, Abrams need not compel a different result because it declared that possibility of abuse was irrelevant where stock was traded for cash. This allowed the court to impose liability, not on the theory that Crane's merger exchange of Air Brake stock for Standard stock was a "sale" of Air Brake stock, but on the hitherto virtually ignored theory that the ultimate cash sale of Standard stock could be considered a section 16(b) sale of the Air Brake stock. In effect, the Abrams analysis forced the court to reach the Alice-in-Wonderland conclusion that a sale of Standard stock is the same as a sale of Air Brake stock, in spite of the earlier conclusion that there was no economic equivalence between the two securities.

situation—whether or not it involves an “unorthodox” transaction—where abuse is impossible: “Congress adopted the sweeping, arbitrary regulatory mechanism embodied in Section 16(b) in order to insure that even the possibility of insider abuse was deterred, but it would seem to follow that in order to avoid ‘purposeless harshness’ a court should first inquire whether a given transaction could possibly tend to accomplish the practices Section 16(b) was designed to prevent.”

In other words, the maxim *cessante ratione legis, cessat et ipsa lex*, should apply.

specific authorization for the use of the “possibility of abuse” test in all cases can be found in the statute’s preamble, which states the statutory policy to be “preventing the unfair use of information which may have been obtained by an insider by reason of his relationship to the issuer.” As one commentator has noted, “[t]he provisions which follow this preamble are clearly intended to be operative only insofar as they promote this policy; to apply those provisions where this purpose is not being furthered [that is, where there is no possibility of abuse] is to go beyond the expressed design of the statute.”

Furthermore, the use of the broad “possibility of abuse” test in cases involving orthodox transactions is not barred by the express statutory limitations on the scope of the court’s inquiry, for the broad test considers neither the insider’s intent nor the actual existence of abuse.

More importantly, the policies that motivate the current broad inquiry into possibility of abuse in cases involving a purchase-sale question are also relevant in cases involving only orthodox transactions, suggesting that the “possibility of abuse” requirement is appropriate in all cases arising under section 16(b). Significantly, the “possibility of abuse” test did not develop simply as a tool of construction to resolve ambiguities in the statutory definitions of “purchase” and “sale.” Rather, the test was intended to ameliorate what the courts saw as the “purposeless harshness” of a wide-ranging but heavy-handed statute. For instance, the Second Circuit, in *Blau v. Lamb*, speaks of the “arbitrary, some might say Draconian,”

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133. See text accompanying note 118 supra.
135. Comment, 117 U. PA. L. Rev. 1034, supra note 8, at 1044.
139. 363 F.2d at 515.
nature of section 16(b) and remarks that "[i]t might be said that Congress decided in order to throw out the bathwater that the baby had to go, too." Another court has stated that in the case before it, the "crude rule of thumb" created by the statute would become the "extremely crude rule of a most deformed and misshapen thumb." The potential harshness of section 16(b) flows from the statute's refusal to consider actual innocence or guilt; the insider is presumed to have abused inside information simply by virtue of his profitable transactions and their proximity in time. The presumption is as likely to lead to unduly harsh results in cases involving orthodox transactions as it is in cases involving unorthodox transactions. Thus, it is inconsistent to look to the possibility of abuse in one group of cases and not in the other. Still, the arguments for restricting the scope and the use of the "possibility of abuse" test must not be understated. Even as limited by Kern County, the test has given birth to much litigation and confusion. To some extent, the charge that the courts have created a muddled test that destroys the deterrent function of section 16(b) is justified. It is worth asking, however, whe-

141. 363 F.2d at 515.
143. Professor Loss has termed section 16(b) "the most cordially disliked provision" of all of the disclosure-related requirements. 2 L. Loss, supra note 6, at 1087.
144. Were this stern conclusive presumption not tempered by an inquiry into such matters as disclosure and lack of access, it is even possible that a constitutional due process challenge could be launched against section 16(b). Section 16(b) has been explicitly upheld against such a challenge on a number of occasions. See, e.g., Gratz v. Clauthon, 187 F.2d 46, 49-50 (2d Cir.), cert. denied, 341 U.S. 920 (1951); Park & Tilford, Inc. v. Schulte, 160 F.2d 984 (2d Cir.), cert. denied, 332 U.S. 761 (1947); Smolove v. Delendo Corp., 156 F.2d 231, 239-40 (2d Cir.), cert. denied, 320 U.S. 751 (1947). However, a new appraisal is warranted in the light of such cases as Vlandis v. Kline, 412 U.S. 441 (1973), holding that a permanent and irrebuttable statutory presumption of nonresidency for university tuition purposes is invalid where the presumption is arbitrary, where it is not necessarily or universally true in fact, and where alternate means of determination are available. 412 U.S. at 448, 451-52. Even in the absence of constitutional problems, however, the potential harshness of section 16(b) is serious enough to justify an extension rather than a restriction of the "possibility of abuse" test.
145. The harshness of section 16(b) is not sufficiently mitigated by the power of the Securities and Exchange Commission to exempt "any transaction or transactions . . . not comprehended within the purpose of [the] subsection." 15 U.S.C. § 78p(b) (1970). The courts have already recognized that administrative action is inadequate and that the wiser policy is to create flexible judicial doctrines for applying the statute:

... the primary duty of administering § 16(b), unlike other provisions of the [Exchange] Act, is not imposed upon the Commission, but upon the courts through the medium of stockholder suits. Moreover, the Commission has been slow to exercise its power of exemption. In these circumstances, whether § 16(b) is to have a flexible or mechanistic application in practice must depend upon the courts.

146. Courts have, in the past, expressed a strong disinclination to adopt "black-letter rubrics" in dealing with section 16(b) problems. See, e.g., Ferraiolo v. Newman, 229 F.2d 342, 344 (6th Cir. 1956), cert. denied, 355 U.S. 927 (1959); Roberts v. Eaton, 212 F.2d 82, 85 (2d Cir.), cert. denied, 348 U.S. 827 (1954). It is this sentiment, perhaps coupled with
ther the litigation surrounding the “possibility of abuse” standard is due to the inherent weakness of the test or to the failure of courts to enunciate the factors that should guide its application.

uncertainties about statutory purpose, that has led courts to avoid a clear enunciation of the elements required for a showing of “possibility of abuse.” The lack of such an enunciation, however, is surely at the root of much of the criticism of the pragmatic approach. Witness Justice Douglas’ reaction to the majority holding in Kern County:

“Thus, the courts will be caught up in an ad hoc analysis of each transaction, determining both from the economics of the transaction and the modus operandi of the insider whether there exists the possibility of speculative abuse of inside information. Instead of a section that is easy to administer and by its clearcut terms discourages litigation, we have instead a section that fosters litigation . . . .” 411 U.S. at 612 (dissenting opinion).

Certainly Justice Douglas is correct in emphasizing the need for predictability in the application of section 16(b). The statute functions primarily as a deterrent, not as a compensatory remedy. This is brought out by the statute’s statement of purpose (“For the purpose of preventing . . .”) and legislative history, as well as by the fact that recovery goes to the issuer, which has arguably not been harmed by insider trading in its shares. Thus, as one court has noted, the principal effect of section 16(b) has been to place the “responsibility for meticulous observance of the provision upon the shoulders of the insider.” Bershad v. McDonough, 428 F.2d 695, 696 (7th Cir. 1970), cert. denied, 400 U.S. 992 (1971). Accord, Popkin v. Dingman, 366 F. Supp. 534, 537 (S.D.N.Y. 1973).

It is unreasonable to place the burden of “meticulous observance” of a statute on an investor without also providing a relatively certain standard against which his dealings may be measured. Furthermore, section 16(b) should be predictable for a number of economic reasons. Any benefit derived from regulation of trading has the corresponding cost of disturbing market equilibrium by introducing noneconomic factors, such as the possibility of civil liability, into the investor’s calculus. Institutionalization of a noneconomic consideration is justified only by benefits flowing from the application of the regulation. Where a regulation is uncertain in its application, however, an investor may avoid an investment on the erroneous assumption that the statute prohibits it. This is an intrusion of noneconomic factors into the market situation, a theoretical cost, without the corresponding benefit of deterring prohibited conduct. There is no benefit because the investment that was “deterred” was not prohibited and presumably not undesirable.

An uncertain statute in the securities context also contributes to an imperfect allocation of resources since fear of potential liability may deter investment in some profitable enterprises which, by hypothesis, either are relatively efficient compared with other firms in their industry or are in a sector of the economy which can effectively utilize additional resources. However, the attempt to introduce predictability into the application of section 16(b) need not produce an unyielding, harsh statutory application, as some writers have suggested. See, e.g., 2 L. Loss, supra note 6, at 1089-90: “[I]t would be illusory to pretend that one could ever have both equity and relative automaticity.” A compromise may be struck by utilizing a flexible standard composed of easily determined, fairly objective inquiries such as has been proposed here.