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Securities: Corporation's Recapture of Insider's Short-Swing Profits

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The court did not recognize the difference between the president and fiduciary of a corporation and a person acting as a private owner. However, without expressly saying so, the reasoning of the decision is not bottomed on sound principles and is open to serious debate.

In the alternative, the court may not have pierced the corporate veil, but developed its own position in this type of creditor's priority situation. It would hold that an equitable mortgagee, because of value given for a security interest, would stand ahead of a mere judgment creditor who dockets in the interim.

In conclusion, the most tenable solution would be to assume that on these particular facts, when a president and sole shareholder owns real property individually and his corporation mortgages it, he will be held to have joined in the mortgage and to have mortgaged his own property.

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Securities: Corporation's Recapture of Insider's Short-Swing Profits—Technical areas of the law can be fascinating. A person unskilled in a complex field, such as securities regulation, has difficulty appreciating the subtlety of the issues buried in the language of a court's opinion. Even the corporate planner often overlooks any esoteric quality amid his contriving to avoid expensive pitfalls for clients. Of particular interest are the problems which have plagued the application of the deceptively simple insider-trader provision, Section 16(b) of the Securities Exchange Act of 1934.[1] In the nearly forty years of the statute's existence, the United States Supreme Court has consistently denied certiorari to every case which turned on a construction of the section. *Reliance Electric Co. v. Emerson Electric Co.*[2] for the first time attempts to set

1. 15 U.S.C. § 78p(b) (1964) hereinafter cited as 16(b).

2. 404 U.S. 418 (1972). The only other 16(b) case which reached the United States Supreme Court did not involve a construction of the terms "purchase and sale," but rather involved the liability of a partner-director. Blau v. Lehman, 368 U.S. 403 (1962). There had been confusion in the lower federal courts as to what policies were to guide the applicability of the statute. *Reliance*, for the first time, attempts to define what types of transactions are "purchases" and "sales" covered by 16(b). The statute has been a fruitful source of litigation, mainly because, although the plaintiff himself recovers nothing directly (the profit recaptured inures to the issuing corporation), the courts have liberally awarded attorney's fees, usually in the form of a percentage of the total recovery. For example, in Blau v. Brown and Western Nuclear, Inc., [1967-1969 Transfer Binder] CCH FED. SEC. L. REP. 92,263

forth the approach for determining the types of security transactions which trigger the imposition of 16(b) liability. In a 4-3 decision the Court held that the method used by a corporate insider to dispose of stock did not constitute a "sale" which would require a forfeiture of the over $715,000 profit realized because ". . . the method used to 'avoid' liability is one permitted by the statute."[3]

Hearings during the Great Depression disclosed that widespread manipulations by insiders played a part in the stock market decline. The most prevalent abuse involved profitting on advance information by timing stock transactions with the corporation's announcement of new developments (which had the expectable consequence of stort-lived jumps in security market prices).[4] Congress intended to protect the investing public[5] by either prohibiting all trading by those with access to inside information, or preventing only abusive and fraudulent practices.[6] Opting for ease of administration, the compromise wording of 16(b) was made simple and inflexible for maximum deterrence. It provides that any officer, director or more than 10% stockholder who engages in a short-swing transaction (purchase and sale within six months) forfeits the profits to the corporation regardless of motive or actual use of inside information.[7]

(S.D.N.Y. 1968), also noted in H. HENN, LAW OF CORPORATIONS 605-606 n. 41 (2d ed. 1970), an amount equal to 20% of the short-swing profits recovered for the corporation, or $7500, was awarded to an attorney who did no more than file a routine complaint. The justification is that such fees provide the sole stimulus for the vigorous enforcement of the statute. Comment, *Insider Trading: The Issuer's Disposition of an Alleged 16(b) Violation*, 1968 DUKE L. REV. 94,103. Isadore Blau, represented by Morris J. Levy Esq., has been the predominant plaintiff in the development of 16(b) case law.

3. 404 U.S. at 422.

4. *See, e.g.*, citations collected, *id.* at 428-431 nn. 2-7.

5. Prior to the passage of 16(b) breaches of fiduciary duties of insiders were inadequately regulated. Aggrieved stockholders generally had no right to recover for the corporation any insider profits except under the "special circumstances" rule of Strong v. Repide, 213 U.S. 419 (1909). However, even this remedy was inadequate because of the heavy burden of proof imposed upon the stockholders—usually to prove an actual use of inside information.

6. Painter, *Section 16(b) of the Securities Exchange Act: Legislative Compromise or Loophole*, 113 U. PA. L. REV. 358 (1965); Comment, *The Application of Section 16(b) to Mergers: A Hidden Hazard*, 47 TEXAS L. REV. 1417 (1969).

7. Section 16(b) provides in relevant part:

> 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 . . . within any period of less than six months . . . shall inure to and be recoverable by the issuer, *irrespective of any intention* on the part of such . . . owner . . . in entering into such transaction of

Since 1934 the federal courts have applied 16(b) as a "crude rule of thumb," imposing strict liability based upon objective standards in order to cover the evil with the "optimum prophylactic effect." Upon proof of any set of transactions by an insider within six months, which in some way resembled a "purchase" and "sale," the courts would conclusively presume an abuse of his position and automatically hold him liable.[8] This harsh, no-excuses-taken approach was regarded as vital to protect the public. Problems arose because the simple language of 16(b) did not cover complex exchange situations such as the conversion of bonds or preferred stock into common shares, the granting and subsequent exercise of options and warrants for the purchase of common shares, the reclassification of securities in a corporate reorganization and the intercompany security transfers involved in the acquisition of another corporation. Also, where the facts indicated that a 10% owner had no access to information, the "statutory fiduciary" concept was seriously questioned. As a result of the inadequacy of the statute as written, courts were forced to resort to specious logic to achieve a desired outcome.[9] Consequently, case law afforded little help in formulating an on-going rule to guide clients.

> holding the security purchased or of not repurchasing the security sold for a period exceeding six months. . . . *This subsection shall not be construed to cover any transaction where such beneficial owner was not such both at the time of the purchase and sale, or the sale and purchase*, of the security involved, or any transaction or transactions which the Commission by rules and regulations may exempt as not comprehended within the purpose of this subsection. (Emphasis added.)

A beneficial owner covered by 16(b) is defined by Section 16(a) as: "Every person who is directly or indirectly the beneficial owner of more than 10 percentum of any class of any equity security . . . ." 15 U.S.C. § 78p(a) (1964).

8. The two leading cases illustrating this approach are Smolowe v. Delendo Corp., 136 F.2d 231 (2d Cir. 1943), *cert. denied*, 320 U.S. 751 (1943), and Park & Tilford, Inc. v. Schulte, 160 F.2d 984 (2d Cir. 1947), *cert. denied*, 332 U.S. 761 (1947). Munter, *Section 16(b) of the Securities Exchange Act of 1934: An Alternative to 'Burning Down the Barn in Order to Kill the Rats'*, 52 CORNELL L.Q. 69 (1966). Bershad v. McDonough, 428 F.2d 693, 696 (7th Cir. 1970), *cert. denied*, 400 U.S. 992 (1971). *See also* Heli-Coil Corp. v. Webster, 352 F.2d 156 (3d Cir. 1965).

9. For instance, the courts have held a "purchase" to include a conversion from preferred to common stock, Heli-Coil Corp. v. Webster, 352 F.2d 156 (3d Cir. 1965); stock disposed of through a consent decree in an antitrust action, Western Auto Supply Co. v. Gamble-Skogmo, Inc., 348 F.2d 736 (8th Cir. 1965), *cert. denied*, 382 U.S. 987 (1965); and transfers of stock from a subsidiary to its parent, Blau v. Hodgkison, 100 F. Supp. 361 (S.D.N.Y. 1951). Also, a stock option was held to be a "purchase" when exercised, Booth v. Varian Associates, 334 F.2d 1 (1st Cir. 1964), *cert. denied*, 379 U.S. 961 (1965); and a "sale" when granted, Bershad v. McDonough, 428 F.2d 693 (7th Cir. 1970), *cert. denied*, 400 U.S. 992 (1971).

Recently, a few appellate courts, noticing that the morals of the market place are being adequately policed by the anti-fraud provisions of the Securities Exchange Act, began advocating a shift in 16(b) construction to a more pragmatic, fact-oriented and subjective approach.[10] The threshold question in the ad hoc analysis is whether the particular transaction could possibly fit within the ambit of the practices which Congress intended to eliminate.[11] Once a potential for abuse is discovered, the stringent "crude rule of thumb" provisions are applied in full force.[12] The objective of the present analysis is to determine *Reliance's* contribution to the federal common law concerning the proper application of 16(b).

In an attempt to wrest control from the incumbent management and force a merger, Emerson Electric Co. purchased 13.2% of Dodge Manufacturing Corporation in June, 1967.[13] Dodge and Reliance Electric Co. planned a defensive merger which confronted Emerson with certain failure of its takeover attempt and with the prospect of being forced to exchange its Dodge shares for shares of Reliance—the successor corporation. Such an exchange of securities for those of a different company had been determined to be a statutory "sale."[14] Since the purchase of Dodge shares by

10. Lowenfels, *Section 16(b): A New Trend in Regulating Insider Trading*, 54 CORNELL L. REV. 45 (1968).

11. Mr. Justice Stewart (the author of the majority opinion in *Reliance*), while a judge on the Sixth Circuit Court of Appeals, wrote the opinion which embraked on the initial departure from applying 16(b) objectively. The statement of the subjective test was set forth as the standard for decision as follows: "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 16(b)." Ferraiolo v. Newman, 259 F.2d 342, 345 (6th Cir. 1958), *cert. denied*, 359 U.S. 927 (1959). The subjective test appears to have come into its own with *Ferraiolo*; since then a trend in the cases toward the subjective approach has become clearly discernible. 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); Blau v. Max Factor & Co., 342 F.2d 304 (9th Cir. 1965), *cert. denied*, 382 U.S. 892 (1965); Booth v. Varian Associates, 334 F.2d 1 (1st Cir. 1964), *cert. denied*, 379 U.S. 961 (1965). Note, *Securities Regulation—Short Swing Profits—Pragmatic Approach to Section 16(b)*, 41 TUL. L. REV. 194 (1966); Comment, *Stock Exchanges Pursuant to Corporate Consolidation: A Section 16(b) 'Purchase or Sale'?*, 117 U. PA. L. REV. 1035 (1969); Hemmer, *Insider Liability for Short-Swing Profits Pursuant to Mergers and Related Transactions*, 22 VAND. L. REV. 1101 (1969).

12. 117 U. PA. L. REV., note 11 *supra*, at 1044.

13. Emerson had attempted to negotiate a merger between itself and Dodge. Since Dodge rejected the merger proposal, Emerson, in an apparent attempt to acquire a majority of the Dodge voting stock and then vote a merger, invited tenders of up to 550,000 shares of Dodge stock at $63 per share. On June 16, 1967, Emerson purchased 152,282 shares of the outstanding Dodge stock. Prior to that date, Emerson owned no shares of Dodge.

14. 404 U.S. at 420 n.2.

Emerson occurred about one month prior to the imminent exchange of those Dodge shares for shares of Reliance, 16(b) liability was inevitable if Emerson did not act immediately. Pursuant to a two-step plan, devised by counsel, whereby it hoped to avoid liability to the extent possible, Emerson sold 37,000 shares in August, thereby reducing its ownership to 9.96%. Thus Emerson had moved out of the over-10% category. Two weeks later the remaining shares were sold to a different buyer. Reliance demanded the over $900,000 profit realized; Emerson offered to pay only the $185,000 profit from the first sale, at which time it had still been an over-10% owner. In an independent action, a court found that ". . . Emerson did not have any 'insider' information about Dodge and that all its knowledge about Dodge had been obtained from publicly available sources."[15]

Section 16(b) provides that a more-than-10% owner is subject to liability only if he were such "at the time of purchase and sale." The ambiguity of this phrase presented the only loophole. Lack of a comprehensive definition of the terms "purchase and sale" left the status of unusual exchange transactions in doubt.[16] Also, the words "at the time of" could be interpreted to mean any one of three instances relative to the particular event—just prior to, simultaneously with, or immediately after. For example, did the section cover a situation where the condition of over-10% ownership did not exist before a purchase, but did after? The right to over $900,000 was to be determined by semantics.

Emerson's strategy was to argue initially that it did not have to disgorge any profit because the purchase was not covered by 16(b). In the alternative, a definition of "sale" was sought which would exclude its second disposition. Thus, Emerson commenced the declaratory judgment action contending that under the particular facts it was not a 10% owner within the meaning of the statute 1) at the time of purchase, because "just prior" to the purchase it

15. Emerson Electric Co. v. Reliance Electric Co., 434 F.2d 918, 920 n.5 (8th Cir. 1970). Although this fact is irrelevant in the application of the statute under any method, it is important in noticing the equitable operation of 16(b) in relation to its original purpose.

16. The definitions of these terms are found in the general definitional section of the Act. The term "'purchase' . . . include[s] any contract to buy, purchase or otherwise acquire." Securities Exchange Act of 1934, § 3(a)(13), 15 U.S.C. § 78c(a)(13) (1964). The term "'sale' . . . include[s] any contract to sell or otherwise dispose of." *Id.*, § 3(a)(14), 15 U.S.C. § 78c(a)(14) (1964). While everyday transactions through a broker are clearly included within these broad definitions, the status of less ordinary, "unorthodox," acquisitions and dispositions has often been uncertain.

did not own any Dodge shares,[17] or 2) at the time of the second independent sale because the first sale reduced its holdings to 9.96%.[18]

Reliance attempted to fit the situation within the literal words of the statute by contending that Emerson was an over-10% owner 1) at the time of purchase, because 13.2% ownership was acquired "simultaneously with" the purchase,[19] and 2) at the time of both sales because a statutory sale encompasses a series of related transactions pursuant to a plan of disposition.[20]

The district court agreed with Reliance.[21] The Eighth Circuit Court of Appeals affirmed the use of the "simultaneously with" test for the time of purchase,[22] but reversed on the ground that a statutory sale is a single transaction or occurrence—an independent sale "not legally tied to" another sale, made at a different time to a different buyer.[23] Citing *Helvering v. Gregory*[24] as an analogous situation, the court held that a person may ". . . conduct his business in such a way as to intentionally minimize or eliminate his loss of profits under Section 16(b) by any means permitted by law."[25] Thus the court condoned Emerson's split-sale transaction and held that intent to avoid liability is irrelevant.

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17. Emerson Electric Co. v. Reliance Electric Co., 306 F. Supp. 588, 589 (E.D. Mo. 1969), and 434 F.2d at 922.

18. 306 F. Supp. at 590-591, and 404 U.S. at 421.

19. 434 F.2d at 922.

20. 404 U.S. at 421-423. The SEC supported Reliance's unsuccessful contention in an amicus curiae brief in which it argued that the congressional purpose of the requirement of 10% ownership at the time of both purchase and sale was to cover all sales within six months by one who had acquired 10% through voluntary purchase, and to exclude those who became 10% shareholders "involuntarily" (e.g., by legal succession or by a reduction in the total number of outstanding shares of the corporation). It was contended that this interpretation would not only cover Emerson's transactions, but would also preserve the mechanical quality of the statute. The Court rejected the argument. One reason given was that such a construction "flatly contradicts the words of the statute." Affirming a policy enunciated in Blau v. Lehman, 368 U.S. 403 (1962), the Court in effect said that regardless of how persuasively the SEC may argue for an expansion of 16(b) coverage, the federal courts must limit ". . . forfeiture of profits [to] only . . . those specifically designated by Congress to suffer those losses." *Id.* at 425-426. For the second reason given, see note 36 *infra*.

21. 306 F. Supp. 588.

22. 434 F.2d at 923-924.

23. *Id.* at 926.

24. 293 U.S. 465, *aff'g* 69 F.2d 809 (2d Cir. 1934), which stands for the proposition that desire to avoid taxation by arranging one's affairs such that his taxes will be as low as possible is permissible. The taxpayer has "[t]he legal right . . . to decrease the amount of what otherwise would be his taxes, or altogether avoid them, by means which the law permits . . ." *Id.* at 469.

25. 434 F.2d at 925.

The only issue considered by the Supreme Court was whether approval of this particular set of dispositive transactions, structured to avoid insider liability, is consistent with the underlying principle and purpose of 16(b). Or, stated another way, how should a court analyze a specific situation, in this case the two-step sale, to balance sufficiently the interest in preventing the unfair use of information with the interest in a uniform and rational imposition of liability?

Mr. Justice Stewart, writing for the majority, affirmed the court of appeals and extended the rationale. The opinion is based upon the proposition that where an opportunity for abuse is inherent in the particular type of transaction, and the application of 16(b) would serve the congressional purpose of curbing short-swing speculation (the pragmatic approach), then the transaction in question constitutes a statutory purchase or sale, which, if matched within six months by an insider, results in automatic liability.[26]

The majority offered two reasons to support its conclusion that the application of 16(b) to Emerson's second sale would not serve the purpose of the statute. First, Congress intended to cover only those transactions where the possibility of abuse is intolerably great. The "intolerable possibility" test is objective and is met when a 10% owner is such "both at the time of purchase and sale."[27] Further, Congress determined that the chance of abuse is minimal where a short-term owner moves in and out of the 10% category.[28] Since an objective "sale" constitutes a single, independent transaction or occurrence, and the first sale moved Emerson out of the 10% category, the potential for subsequent abuse was tolerable, and thus the profit from the second step of the two-step sale was not covered by 16(b). Secondly, Congress intended to have liability predicated upon an objective measure of proof. Treating

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26. *Supra* note 11. Mr. Justice Stewart reasoned as predicted along the lines of the pragmatic approach which he conceived in Ferraiolo v. Newman, 259 F.2d 342 (6th Cir. 1958), *cert. denied*, 359 U.S. 927 (1959).

> The Supreme Court has never passed upon which of the two interpretations it considers appropriate to implement the Congressional intent of the section, but Justice Stewart, . . . authored the opinion which embarked on the initial departure from applying 16(b) objectively . . . so we at least have a good indication of which way he would lean if and when the question is ever before the Court.

Davis, *Conversions as Purchases and Sales Under Section 16(b) of the Securities and Exchange Act of 1934*, 24 BUS. LAW. 1109, 1110 (1969).

27. 404 U.S. at 422-423.

28. ". . . [I]t may be that Congress regarded one with a long-term investment of more than 10% as more likely to have access to inside information than one who moves in and out of the 10% category." *Id.* at 424.

two sales as one upon proof of a pre-existing intent by the seller to avoid liability would detract from the mechanical quality of the statute.[29] Proof of intent is not objective, therefore Emerson is not liable.

Now the question arises: what effect does *Reliance* have on previous 16(b) case law? The obvious precedents set by the majority are:

1. The pragmatic trend in the analysis of unorthodox, complex transactions as constituting statutory purchases or sales is given the highest authoritative approval. The Court resolved the doubts and lingering confusion;[30] no longer is a literal, rigid interpretation of 16(b) to be applied.
2. The "possibility of abuse" test was extended to an "intolerable possibility" test.
3. The federal courts still refuse to inquire into the insider's intent, to the extent that liability will not be imposed merely because the investor intended to avoid such (*i.e.*, technical formality controls over the substance of the transaction).
4. When an owner of more than 10%, without actual access to information, in the face of involuntary imposition of 16(b) liability, executes a two-step sale whereby the first sale reduces his holdings to less than 10%, then the profit from the second sale is immunized from liability.

The case-by-case search for an "intolerable possibility of abuse" undoubtedly removes some of the inflexibility and hardship, but it does not solve the fundamental problem involved in the application of 16(b) where no inside information is used for personal profit. Emerson nevertheless forfeited the $185,000 profit from the first sale (while it was still a 10% owner). Will the courts extend the reasoning to say that total profits are exempt? When are ostensibly separate sales not "legally tied?"[31] A business lawyer seeks certainty in the form of a general rule to guide clients in avoiding expensive litigation. There is little certainty in diverse

29. *Id.* at 425.

30. "Until the Supreme Court does so state [its preferred construction], however, I must, in good conscience, adhere to my literal and objective construction preference. . . . Perhaps the Supreme Court one day will tell us how these somewhat conflicting approaches to § 16(b) by the Courts of Appeals are to be resolved." Judge (now Mr. Justice) Blackmun's dissent in Petteys v. Butler, 367 F.2d 528, 538 (8th Cir. 1966), *cert. denied*, 385 U.S. 1006 (1967). Justice Blackmun was a member of the Court's majority in Reliance. 40 U.S.L.W. 4125 (U.S. Jan. 11, 1972).

31. For an elaboration on this *quaere* see 404 U.S. at 437 n. 11, *citing* 5 GA. L. REV. 584, 590 (1971), which is aimed at the court of appeals decision, 434 F.2d 918.

judicial attitudes as to the degree of abuse inherent in a particular situation.[32] The majority's threshold search for congressional intent would be practicable if such were clear. Instead, intent was compromised in the final verbal expression of the statute, and the courts are not sure of exactly what transactions are covered (all insider trading or only some practices) and how rigidly (strict liability based upon objective standards, or allowance of defenses). Thus the pragmatic approach of the majority involves an initial conjecture as to whether Congress in 1934 would have been abhorred by a 1967 fact situation which was "not comprehended within the purpose" of the statute[33]—a search for the will-o'-the-wisp of legislative intent.

In furthering his favored construction through strained reasoning, Mr. Justice Stewart may have exposed the weak premise inherent in the approach. The extreme technicality that gives no certainty to the application of 16(b) may, to some degree, be a "mutilation of the Act" as Mr. Justice Douglas stated in dissent.[34] Hope for clarification from the source—Congress—has long been abandoned,[35] and the power of the Securities Exchange Commission to exempt transactions is still subject to doubt.[36] Thus any

32. 117 U. PA. L. REV. *supra* note 11, at 1060.

33. The label given to transactions which the final phrase of 16(b) authorizes the SEC to scrutinize and exempt from the operation of 16(b) if it were to see fit.

34. 404 U.S. at 428. Justice Douglas used the same comment in his dissent to the majority's analysis in Blau v. Lehman, 368 U.S. 403 (1962), the only other direct 16(b) case to reach the United States Supreme Court. *Reliance* appears to be the result of a long-festering difference of opinion as to 16(b) construction. Justice Stewart prevailed in *Reliance* because he was able to win over the tie-breaking member of the Court. The reasoning is contrary to Blau v. Max Factor & Co., 342 F.2d 304 (9th Cir. 1965), *cert. denied*, 382 U.S. 892 (improper use of inside information by corporate insiders is most likely to occur in short-term, in-and-out trading).

35. Immediately after enactment of 16(b), clarifying amendments were advocated to nip in the bud the accurately predicted litigational problems. Seligman, *Problems Under the Securities Exchange Act*, 21 VA. L. REV. 1, 34 (1934). In the almost forty years of the section's existence, Congress has rarely limited or restricted its coverage. Munter, *supra* note 8, at 100, proposed substantial revision in 1966. Lowenfels, *supra* note 10, at 64, concluded in 1968 that legislative action was not likely and that the solution would lie in further judicial construction.

36. *Supra* note 33. "The courts have read this limitation to mean that they [the courts] have the authority to determine whether a particular transaction lends itself to insider abuse even if it comes within the terms of an SEC exemption." 47 TEXAS L. REV. *supra* note 7, at 1429. Pursuant to its authority, the SEC has promulgated S.E.C. RULE 16a-10, 17 C.F.R. § 240.16a-10 (1953), providing that transactions not required to be reported under 16(a) are exempt from 16(b) as well. A 10% owner is required by 16(a) to report at the end of each month any changes in his holdings in the corporation during that month. The SEC interpreted 16(a) to require a report only if the stockholder held more than 10% at some

improvement must come from further judicial construction.

The minority opinion in *Reliance*, using essentially the same case law authority,[37] goes to the heart of the problem and suggests a viable solution. The dissent is based upon the proposition that all transactions by an insider falling within the broad language of 16(b) are automatically presumed to be tainted by the proscribed activities (the "crude rule of thumb" approach). But the new proposal is that the defendant may rebut the presumption by carrying the affirmative burden of proving that his particular ". . . series of dispositive transactions were not of a type that afforded him an opportunity for speculative abuse of his position as an insider."[38] This viewpoint is justified on the ground that Congress intended to have 16(b) apply to *all* insider purchases and sales,[39] not just those where the possibility of abuse is intolerably great. Also, Congress primarily intended to reduce the plaintiff's burden, not merely to make the proof completely objective (which operated in this case to insulate the insider's profts).[40]

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time during the month. FORM 4, *Statement of Changes in Beneficial Ownership of Securities*, RELEASE NO. 6487 (March 9, 1961), 17 C.F.R. § 249.104 (1962). Emerson was a 13.2% owner at the time of its August 28 sale whereby its holdings were reduced to 9.96%; its second sale (the profit from which is the subject of the litigation presently under analysis) was on September 11. Presumably Emerson's second sale would be exempt from the 16(a) reporting requirements and hence from 16(b) liability. The majority in *Reliance* affirmed the exemptive power of the SEC by using it as additional authority for holding Emerson not liable under 16(b) and for rejecting the SEC's amicus curiae argument. 404 U.S. at 426. Therefore it appears to be the "law of the land" that the SEC has the power to exempt transactions from the operation of 16(b), and that this power is beyond the scope of judicial review, rejecting Green v. Dietz, 247 F.2d 689 (2d Cir. 1957). But Mr. Justice Douglas castrates this proposition by pointing out that Feder v. Martin Marietta Corp., 406 F.2d 260 (2d Cir. 1969) held ". . . that Rule 16a-10 was invalid, insofar as it operated through Form 4 to exempt transactions by ex-directors from liability under § 16(b)," because it ". . . was 'an arbitrary [and] unnecessary loophole in the effective operation of the statutory scheme,' *id.*, 406 F.2d at 269." 404 U.S. at 441. In response to *Feder* the SEC removed the arbitrariness as it applied to directors by requiring disclosure of all transactions within six months before appointment, and six months after resignation. S.E.C. RULE 16a-1, 17 C.F.R. § 240.16a-1 (d,e) *as amended* Sept. 30, 1969. "Thus, the restrictive reporting requirements relied upon by the majority apply only to beneficial owners [of over 10%], itself an arbitrary distinction." 404 U.S. at 441 n.14. Therefore, the rule (allowing ex-10% owners to escape 16(b) liability merely by postponing the second sale until the following month), when under attack, would also fall as being "an arbitrary and unnecessary loophole in the effective operation of the statutory scheme." The result is that the exemptive power of the SEC is still in a state of confusion.

37. The majority and the court of appeals, 434 F.2d 918, used the same case law in holding Emerson not liable under 16(b) for the profits of its second sale.

38. 404 U.S. at 440.

39. *Id.* at 430, 442.

40. *Id.* at 431 n.8.

Mr. Justice Douglas desired to hold Emerson liable for the profits of both sales by reasoning that the terms of the statute were intentionally left simple so as to be construed broadly to cover many "unorthodox" transactions. According to the minority opinion, a broad definition of "sale" easily comprehends "the sequence of relevant transactions" pursuant to a single plan of disposition, *i.e.*, substance rather than technical formality. Therefore both parts of Emerson's split-sale were covered by 16(b), and the automatic presumption was triggered.[41] Since Emerson conceded that it could not meet the burden of proof necessary to rebut,[42] and since "[t]he potential for abuse of inside information in the present case is self-evident,"[43] the presumption should control and Emerson should be held liable.

If purporting to remove the harshness and improve the application of 16(b), why did not the minority also find that Emerson's profit from the second sale was exempt, and extending the reasoning, why was the profit from the first sale covered? In other words, why a dissent rather than a concurring opinion? The answer might lie in the fact that the case came to trial mostly on stipulated facts,[44] part of which conceded that Emerson could not carry the burden of proving that there was no possibility of abuse inherent in the particular situation.[45] In theory, Justice Douglas' proposal would eradicate profitting on advance information and allow for certainty by letting the presumption control whenever the insider could not produce the required elements sufficient to rebut.[46] But how does the defendant allege and prove that his transactions were such that the door to speculative gain was not open? How could Emerson, which had no actual access to inside information, prove that there was no possibility for abuse? The effect of the presumption is to say that all corporate insiders are basically dishonest and that the burden should be placed upon the particular insider who claims to be honest. Development of the idea requires definition of the degree and type of evidence needed to rebut so the defendant can apply his own business judgment as to the practicability of defending or settling. Prior cases suggest that the following factors

41. *Id.* at 432, 438-439.

42. *Id.* at 440 n.13.

43. *Id.* at 434.

44. 306 F. Supp. at 589, 592; 434 F.2d at 920 n.3.

45. *Supra* note 42.

46. Mr. Justice Douglas' approach had been previously proposed. *See, e.g.*, Munter, *supra* note 8, at 90-94, and Painter, *supra* note 7, at 380.

are, to some degree, determinative. First, the exchange was of an involuntary nature in that the over-10% owner did not (or it was highly improbable that he did) influence the establishment of the purchase price, the exchange ratio or the time of the exchange.[47] Second, a change of circumstances occurred between the purchase and sale.[48] Third, the exchange transaction involved "economic equivalents."[49] Fourth, all information obtained was from publicly available sources.[50]

Shifting the burden of producing the evidence appears to be more consistent with the simple language of the statute than does sophist reasoning based upon elusive legislative intent. Future cases will determine the better approach. If a court, based upon the plaintiff's argument, analyzes the particular transaction to determine if it is a proscribed "purchase" or "sale" before announcing liability, then Justice Stewart's approach is being furthered. On the other hand, a court may limit the holding of *Reliance* to the proposition that the strict, literal interpretation of 16(b) is no longer to be applied, and determine tentative liability upon plaintiff's presentation of a prima facie case. The court would then proceed to analyze the defendant's arguments as to why the corporation's disclosure of market-affecting information could not have given him an unfair advantage in his particular exchange, conversion or other "unorthodox" transaction such that the imposition of 16(b) liability would be unjustly harsh. The latter is the approach advocated by Justice Douglas.

Until further clarified by the courts, the particular questions which now plague the practicing corporate attorney are: Who must

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47. Newmark v. RKO General, Inc., 425 F.2d 348 (2d Cir. 1970), *cert. denied,* 400 U.S. 855 (1970); Adler v. Klawans, 267 F.2d 840 (2d Cir. 1959); Ferraiolo v. Newman, 259 F.2d 342 (6th Cir. 1958), *cert. denied,* 359 U.S. 927 (1959). 47 TEXAS L. REV. *supra* note 7, at 1430; 117 U. PA. L. REV. *supra* note 11, at 1055.

48. "In general, an insider could perhaps defeat the presumption . . . by showing 'changed circumstances' similar to those required to avoid registration requirements under the private offering exemption of the 1933 Act. See 1 Loss, Securities Regulation, 665-673 (1961); 4 Loss, Securities Regulation, 2646-2654 (1969)." 404 U.S. at 440 n.13.

49. Blau v. Lamb, 363 F.2d 507 (2d Cir. 1966), *cert. denied,* 385 U.S. 1002 (1967); Newmark v. RKO General, Inc., 425 F.2d 348 (2d Cir. 1970), *cert. denied,* 400 U.S. 855 (1970). A conversion is not a sale under 16(b) where that which the insider surrendered and that which he received were simply different forms of the same participation in his issuer. This principle has been held applicable only to exchanges involving the securities of a single issuer. Sales or purchases by an insider of his issuer's securities for cash, the securities of a different company, or other property are within the reach of 16(b). *See also* Blau v. Max Factor & Co., 342 F.2d 304 (9th Cir. 1965), *cert. denied,* 382 U.S. 892 (1965).

50. 434 F.2d at 920 n.5.

come forward with the evidence of a potential for speculative abuse of the insider's position? Is its existence an element of the plaintiff's prima facie case, or is its non-existence an affirmative defense available to the defendant? Allocating the responsibility for pleading and proving the particular factual element is governed by implicit considerations. For policy reasons, which litigant is to be favored? Which party must bear the risk of getting the matter properly before the court? Does the nature of the proof indicate that it lies more within the control of one party, such that in fairness the element should be allocated to him? In order to facilitate the application of either standard for the imposition of liability, the above-mentioned questions need to be answered. Notwithstanding the opinions in *Reliance*, the refinement of 16(b) is likely to be the subject of litigation for many years.

> By now the section's very longevity has increased its life expectancy. Its basic rationale is sound. And the rough diamond is gradually being polished through judicial construction and the SEC's exemptive power . . .—though it would be illusory to pretend that one could ever have both equity and relative automaticity.[51]

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51. 2 L. LOSS, SECURITIES REGULATION, 1089-1090 (2d ed. 1961).