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Securities -- Insiders' Liability Under Section 16(b) on Second Sale in Two-Step Selldown Transactions -- Reliance Electric Co. v. Emerson Electric Co.

Walter C. Spiegel

Securities—Insiders' Liability under Section 16(b) on Second Sale In Two-Step Selldown Transactions—*Reliance Electric Co. v. Emerson Electric Co.*[1]—On June 16, 1967, Emerson Electric Company acquired 13.2 percent of the common stock of Dodge Manufacturing Company at $63 per share, in an attempt to take over Dodge.[2] Prior to this purchase Emerson did not own any Dodge common. Soon after the purchase Dodge shareholders approved a defensive merger with Reliance Electric Company, and Emerson was faced with the prospect of having to exchange its shares of Dodge for stock in the merged corporation.[3] Deciding to sell out completely, Emerson sold 37,000 shares of Dodge on August 28 at $68 per share, thereby reducing its holding in Dodge to 9.96 percent of the outstanding common. The remaining shares were then sold to Dodge at $69 per share on September 11, 1967.[4]

Reliance demanded the profits realized by Emerson on both sales, whereupon Emerson filed an action seeking a declaratory judgment[5] as to its liability under section 16(b) of the Securities Exchange Act of 1934.[6] The federal district court decided first that Emerson became

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1 404 U.S. 418 (1972).

2 In 1966, Emerson was engaged in merger negotiations with Dodge. However, on March 12, 1967, Emerson was advised that Dodge's board of directors had rejected Emerson's merger offer and on March 22, 1967, negotiations terminated. Shortly thereafter Emerson attempted to effect the merger by a tender offer to the Dodge shareholders. As a result of this tender, Emerson acquired 13.2% of Dodge Stock. Emerson Elec. Co. v. Reliance Elec. Co., 434 F.2d 918, 920 (8th Cir. 1970).

3 One reason that this was not an enviable prospect was the possibility that an exchange of stock might be considered a "sale" of the Dodge common. Emerson might then be liable under § 16(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78p(b) 1970, for any profits realized from such a transaction, if the exchange took place within six months of Emerson's June 16 purchase. (See text following notes 25 and 69 infra). Although Emerson could not be sure that courts would construe this exchange as a "sale," and hence find liability under § 16(b), such a construction was a possibility that Emerson wanted to avoid. It appears that divestment was wise: a later case held that in certain situations, exchange of shares in one corporation for those of another pursuant to a merger agreement constitutes a sale within the meaning of 16(b). Newmark v. RKO General, Inc., 305 F. Supp. 310 (S.D.N.Y. 1969), aff'd, 425 F.2d 348 (2d Cir. 1970).

4 This two-step sale procedure has been recommended as a seemingly obvious way to avoid 16(b) liability. See 2 L. Loss, Securities Regulation 1060 (2d ed. 1961) [hereinafter cited as Loss].

5 Emerson Elec. Co. v. Reliance Elec. Co., 306 F. Supp. 588 (E.D. Mo. 1969).

6 Securities Exchange Act of 1934, § 16(b), provides:

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 . . . by the issuer, or by the owner of any security of the a beneficial owner[7] of more than ten percent of the Dodge common when it purchased the stock and thus fell within the scope of section 16(b).[8] The court then ruled that Emerson was accountable for the profits realized from both the first and the second sale, even though at the time of the second sale Emerson was technically no longer a beneficial owner since it owned less than ten percent of the stock. Reasoning that Emerson had disposed of all of its Dodge stock in a single plan of two steps in order to avoid beneficial owner status and hence 16(b) liability on the second sale, the court construed the phrase "at the time . . . of sale" to extend to the second transaction, since it was part of a single plan to dispose of stock.

On appeal, the Court of Appeals for the Eighth Circuit affirmed the finding that Emerson was a beneficial owner at the time of purchase,[9] but reversed the finding that the second sale was covered by 16(b).[10] The court agreed that the two-step selldown process was con-

> issuer in the name of 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 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.

15 U.S.C. § 78p(b) (1970).

7 Section 16(a) defines a "beneficial owner" as one who owns more than ten percent of any class of any equity security which is required to be registered under the Act. 15 U.S.C. § 78p(a) (1970).

8 Section 16(b) imposes liability only on one who was a beneficial owner at the time of purchase *and* the time of sale. See note 6 supra. Emerson had argued that it was not a beneficial owner "at the time" of the purchase of the Dodge stock, contending that "at the time" means prior to, not simultaneous with, the purchase. The gist of the argument was that if being a beneficial owner of more than 10% gives rise to the presumption of access to inside information, then owning less than 10% should not occasion the presumption of access to inside information. Therefore, Emerson maintained, the presumption should be that Emerson had no inside information prior to the purchase and hence this purchase should not come under the purview of 16(b), which was designed to prevent the use of inside information in making both purchases and sales.

However, the district court followed what seems to be the accepted view that "at the time of purchase" means "simultaneous with purchase," and found Emerson to be a beneficial owner "at time of purchase." 306 F. Supp. at 589-90, citing Stella v. Graham-Paige Motors Corp., 104 F. Supp. 957 (S.D.N.Y. 1952), rev'd on other grounds, 232 F.2d 299 (2d Cir.), cert. denied, 352 U.S. 831 (1956). Cf. Newmark v. RKO General, Inc., 305 F. Supp. 310 (S.D.N.Y. 1969), aff'd, 425 F.2d 348, 356 (2d Cir. 1970). But see Arkansas Louisiana Gas Co. v. W.R. Stephens Investment Co., 141 F. Supp. 841 (W.D. Ark. 1956); Stella v. Graham-Paige Motors Corp. 232 F.2d 299, 302-05 (Hincks, J., dissenting). See generally W. Painter, Federal Regulations of Insider Trading 40-42 (1968); Note, Stock Exchanges Pursuant to Corporate Consolidation: A Section 16(b) "Purchase or Sale"?, 117 U. Pa. L. Rev. 1035, 1041-42 n.39 (1969); 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. Rev. 287 (1957); Note, 70 Harv. L. Rev. 1312 (1957).

9 434 F.2d 918, 922-24 (8th Cir. 1970).

10 Id. at 926.

ceived to avoid liability under the Act, but found this plan to be technically legal, comparing it to permissible tax avoidance.[11] The court, relying on the explicit language of section 16(b), which appears to establish objective tests of ownership and sale activity, rather than looking to the subjective purpose or plan underlying the sale, found that after the first sale Emerson no longer owned more than ten percent of the stock and accordingly was not liable under 16(b) for profits from the second sale.

The Supreme Court granted certiorari[12] to consider for the first time the liability of parties who resort to such two-step sales. The Court, applying a literal interpretation of the statute in a 4-3 decision,[13] HELD: when a beneficial owner of more than ten percent of the outstanding stock of a corporation sells its entire holdings in two separate transactions, both within six months of purchase, and when the first sale reduces the holding to less than a ten percent interest, the profits from the second sale are not recoverable under section 16(b) of the Securities Exchange Act of 1934.

Emerson is significant more for the language and reasoning used in reaching the result than for the result itself. For some time, the lower federal courts had been waiting for Supreme Court approval of either the "objective" or "subjective" approach to 16(b) problems.[14] At first glance, *Emerson* seems to be an endorsement of the former and a rejection of the dominant pre-*Emerson* trend in which courts had preferred the latter approach.[15] However, the scope of the *Emerson* holding, and particularly its applicability to dissimilar factual situations, is uncertain.

Before analyzing the *Emerson* decision and its consequences, this note will briefly describe section 16(b) of the Securities Exchange Act of 1934. The historical development of the judicial approaches to certain problems of section 16(b) interpretation will then be traced, culminating with an analysis of *Emerson* in light of the statute and prior case law, in order to determine whether the case should be read as a complete rejection of the trend of judicial interpretation dominant at the time *Emerson* was decided. It will be submitted that it is possible

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11 Id. at 925.

12 401 U.S. 1008 (1971).

13 404 U.S. 418 (1972). The majority consisted of Chief Justice Burger and Justices Stewart, Marshall and Blackmun. Dissenting were Justices Douglas, Brennan and White. Justices Powell and Rehnquist took no part in the consideration of the case.

14 An illustration that the lower courts were waiting for some direction from the Supreme Court as to the proper interpretation of 16(b) is found in the statement of Blackmun, J. [now Justice], dissenting in Petteys v. Butler, 367 F.2d 528, 538 (8th Cir. 1966), cert. denied, 385 U.S. 1006 (1967): "The Supreme Court ultimately may say that [the subjective] view is to be preferred. At least, Mr. Justice Stewart's attitude is apparent from his authorship of the opinion in Ferraiolo v. Newman. Until the Supreme Court does so state, however, I must, in good conscience, adhere to my literal and objective construction preferences." (Citation omitted.)

15 See text following note 58 infra.

to read the decision as being far more limited than its language suggests.

Section 16(b) was enacted to deter corporate directors, officers or beneficial owners of the corporation's equity securities—that is, insiders[16]—from making profits on information available to them as a consequence of their position, but not available to the general public.[17] One objection to insider trading was that it was basically unfair for insiders to be able to rely on information not available to other investors.[18] Secondly, it was felt that insider trading led to abusive practices whereby the interests of the corporation and the shareholders could be subordinated to the personal interests of the insiders.[19]

Section 16(b) thus provides in general that a corporation or an individual shareholder suing on behalf of the corporation may recover profits realized by an insider from any purchase and sale, or sale and purchase of the corporation's equity securities made within a six-month period.[20] Because Congress felt that it would be extremely difficult to prove actual use or intent to use inside information for personal profit, there is no provision requiring such proof.[21] Subsequent case law has held that proof of use of inside information is not required for recovery.[22] Generally, all that has to be shown is that there was a purchase and sale by an insider and a resultant profit within a six-month period. An important provision, however, is that a beneficial owner must

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16 Directors, officers and beneficial owners of a corporation's securities are commonly described collectively as "insiders."

17 See note 6 supra for text of § 16(b).

18 The unfairness is said to stem from the fact that the insider derives benefit from advance information on changing corporate financial policy. Insiders could thus reap large profits at the expense of the unknowing stockholders from whom they bought or to whom they sold. Cook & Feldman, Insider Trading Under the Securities Exchange Act, 66 Harv. L. Rev. 385, 386 (1953).

19 One example of abusive conduct involved the chairman of a corporation's executive committee and a director who organized a pool to trade in the stock of their company. When the pool was organized, the corporation was not paying dividends. Shortly thereafter, when, the officers caused dividends to be declared, the timing of the declaration was such that more than twenty-five percent of the dividends were received by the pool. They were paid in spite of the fact that earnings were not sufficient to cover them and part of the corporation's surplus had to be diverted for that purpose. Id. at 386 n.8, citing S. Rep. No. 792, 73d Cong., 2d Sess. 9 (1934).

20 15 U.S.C. § 78p(b) (1970), quoted in note 6 supra.

21 [Y]ou hold the director [liable] irrespective of any intention of expectation to sell the security within six months after, because it will be absolutely impossible to prove the existence of such intention of expectation, and you have to have this crude rule of thumb because you cannot undertake the burden of having to prove that the director intended, at the time he bought, to get out on a short swing.

Testimony of Mr. Thomas Corcoran, chief spokesman for the drafters of 16(b), in Hearings on S. 84, S. 56 and S. 97 Before the Senate Comm. on Banking and Currency, 73d Cong., 2d Sess., pt. 15, at 6557 (1934).

22 Smolowe v. Delendo Corp., 136 F. 2d 231 (2d Cir.), cert. denied, 320 U.S. 751 (1943).

have held more than ten percent of the corporation's securities at both the time of purchase and the time of sale.[23] This requirement does not apply to officers or directors. It was felt that this "crude rule of thumb"[24] would be a clear-cut, albeit arbitrary approach to the problem of defining conduct within the ambit of section 16(b). Problems soon arose, however, as to whether certain transactions could be defined as purchases or sales.

Generally, the transactions which have given the courts trouble in applying 16(b) are not the ordinary cash purchases and sales but the unorthodox transactions which do not fit the standard concept of purchase and sale.[25] For example, in *Park & Tilford, Inc. v. Schulte*[26] the issue was whether the exercise of an option converting preferred stock into common is a "purchase" of the underlying common, to be linked with the subsequent sale of the common.[27] Other cases questioned whether a conversion of one class of common into another class is a "purchase" of the latter class;[28] whether the exchange of shares of one corporation for shares of a newly formed corporation pursuant to a statutory merger is a "sale" of the shares of the first corporation;[29] and whether the exercise of an option to acquire stock is a "purchase" of the stock when the options were issued to directors as an incentive.[30] It soon became obvious that the language of 16(b) did not resolve these definitional issues and that judicial interpretation was necessary either to expand or to restrict the definitions of "purchase" and "sale."

In seeking to resolve the underlying problem of definition, the courts developed two rationales, known as the objective or "crude rule of thumb" approach and the subjective approach.[31] The objective approach looked only to the arbitrary and automatic language of 16(b), without regard to whether or not the insider actually used or intended to use inside information for personal profit. It was reasoned that Congress had felt that the only way to prevent insider abuses was to establish a test "which applied without question to any transaction which

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23 15 U.S.C. § 78p(b) (1970).

24 Phrase coined by Mr. Thomas G. Corcoran, principal witness at the legislative hearings on section 16(b). Hearings, supra note 21, at 6557.

25 2 Loss, supra note 4, at 1069.

26 160 F.2d 984 (2d Cir.), cert. denied, 332 U.S. 761 (1947).

27 Ferraiolo v. Newman, 259 F.2d 342 (6th Cir. 1958), cert. denied, 329 U.S. 927 (1959), was another case involving the issue of whether the conversion of preferred shares to common was a "purchase" of the common.

28 Blau v. Max Factor & Co., 342 F.2d 304 (9th Cir.), cert. denied, 382 U.S. 892 (1965).

29 Newmark v. RKO General, Inc., 305 F. Supp. 310 (S.D.N.Y. 1969), aff'd, 425 F.2d 348 (2d Cir. 1970).

30 Truncale v. Blumberg, 80 F. Supp. 387 (S.D.N.Y. 1948), aff'd per curiam sub nom. Truncale v. Scully, 182 F.2d 1021 (2d Cir. 1950). See generally Meeker & Cooney, The Problem of Definition in Determining Insider Liabilities Under Section 16(b), 45 Va. L. Rev. 949 (1959).

31 For a more detailed analysis of these approaches see Note, Stock Exchanges Pursuant to Corporate Consolidation: A Section 16(b) "Purchase or Sale"?, 117 U. Pa. L. Rev. 1035 (1969).

came within its terms, thereby eliminating any possibility of error or laxity inherent in discretionary administration by the courts."[32] According to this view, the factual circumstances surrounding the transactions in question are irrelevant.

It should be noted that this refusal to inquire into factual circumstances extended not only to the question of the insider's intent but also to the larger question as to whether there existed any *possibility* of using inside information in connection with the transaction. This conclusion may be drawn from the absence of any such inquiry in the "objective" decisions, while in "subjective" decisions precisely this inquiry was stressed.[33] One commentator has said that the courts using the objective approach interpreted the statutory language "irrespective of any intention on the part of such beneficial owner" as meaning "irrespective of any possibility of unfair use of inside information."[34] The criticism has been made that this approach punished the innocuous as well as the undesirable transaction, in that even the transaction in which insider abuse was impossible fell within 16(b), and that such refusal to look to the possibility of abuse was not required by the language of the statute.[35] Rather, the argument went, courts may look to the existence of a possibility for abuse and still remain as "objective" as the statute requires. That is, for a court to inquire whether or not the possibility of a 16(b) abuse existed, and to apply the statutory sanction only if such possibility were in fact present, did not require the court to look to the insider's intent or to his use or non-use of the inside information. This argument was to become the cornerstone of the "subjective" approach, which would test a transaction by a "possibility of abuse" standard.[36]

Although the objective test was initially used by the courts, only a few cases actually employed it fully.[37] The case most often cited as initiating this approach is *Park & Tilford, Inc. v. Schulte*,[38] decided in 1947. The defendants, beneficial owners of more than ten percent of the plaintiff corporation, which constituted control of the company, converted their non-marketable preferred stock into common stock just as the common was undergoing a spectacular price rise. Within six months they sold the common. The court held that the conversion of the preferred was a "purchase" of the common to be matched with the subsequent sale, stating:

32 Id. at 1039.

33 See text at notes 49-52 infra.

34 Lowenfels, Section 16(b): A New Trend in Regulating Insider Trading, 54 Cornell L. Rev. 45, 58 (1968).

35 See, e.g., Petteys v. Butler, 367 F. 2d 528, 533 (8th Cir. 1966), cert. denied, 385 U.S. 1006 (1967).

36 See, e.g., Lowenfels, supra note 34, at 50.

37 Generally, only three cases are cited as following the objective approach: Park & Tilford, Inc. v. Schulte, 160 F.2d 984 (2d Cir.), cert. denied, 332 U.S. 761 (1947); Blau v. Hodgkinson, 100 F. Supp. 361 (S.D.N.Y. 1951); and Heli-Coil Corp. v. Webster, 222 F. Supp. 831 (D.N.J. 1963), aff'd in part, 352 F.2d 156 (3d Cir. 1965).

38 160 F.2d 984 (2d Cir. 1947).

> Whatever doubt might otherwise exist as to whether a conversion is a "purchase" is dispelled by definition of "purchase" to include 'any contract to buy, purchase, or otherwise acquire'. Defendants did not own the common stock in question before they exercised their option to convert; they did afterward. Therefore they acquired the stock, within the meaning of the Act.[39]

It should be noted that although the language of this decision is criticized as being overly broad because it seems to make any conversion of preferred into common a "purchase" of common,[40] the result of the decision arguably would be considered correct even under the subjective approach, because the facts revealed a real possibility of abuse of inside information.[41] The defendants, owning a controlling interest in the issuing corporation, could have determined when the preferred would be called for redemption, and thus the conversion would not necessarily have been involuntary. Also, because the preferred shares were non-marketable and not protected against dilution, the insiders were exchanging less valuable shares for the more valuable margetable common stock.

Blau v. Hodgkinson,[42] a 1951 decision, also employed the rhetoric of the objective approach. Each of the several defendants was a director of the parent corporation and also an owner of stock in certain subsidiaries. Pursuant to a reorganization, the defendants surrendered their subsidiary stock in exchange for stock in the parent company, which they subsequently sold at a profit within six months of the exchange. The court held that the receipt of the parent stock was a "purchase" under 16(b) and should be matched with the subsequent sale. Again, the actual result may have been correct even under the subjective test for possibility of abuse, in that the defendants could have purchased subsidiary stock with knowledge that it would soon be exchanged for stock with greater value. However, instead of limiting its decision to the particular facts, the *Hodgkinson* court relied on Judge Clarke's language in *Park & Tilford* to the effect that the defendants had not owned the parent stock before the exchange but had owned it afterwards and thus had acquired it within the meaning of 16(b).[43] This language suggests that all such transactions are subject to 16(b) sanctions.

The latest endorsement of *Park & Tilford* is found in *Heli-Coil Corp. v. Webster*,[44] decided in 1965. The defendant, a director of Heli-Coil, purchased convertible debentures in the corporation on November 20, 1958. On March 18, 1959, he converted the debentures into the under-

[39] Id. at 987 (citation omitted).
[40] W. Painter, Federal Regulation of Insider Trading 43-44 (1968).
[41] 2 Loss, supra note 4, at 1067, takes this position.
[42] 100 F. Supp. 361 (S.D.N.Y. 1951).
[43] Id. at 373, citing 160 F.2d at 987.
[44] 352 F.2d 156 (3d Cir. 1965).

lying common and within six months sold the common. The plaintiff claimed that the conversion of the debentures was a "sale" of the debentures and a "purchase" of the common. The defendant, it was argued, should therefore be liable for the increase in value of the debentures from the time of their purchase to the time of conversion and also for the profit from the "purchase" of the common and their subsequent sale. The district court approved of this argument,[45] but the Third Circuit reversed in part, holding the defendant liable only for the profits from the "purchase" and sale of the common.[46] The court agreed that the exchange of the debentures was a "sale" to be matched with the original purchase, but reasoned that the defendant did not actually realize any profit until the underlying common was sold. Although one commentator felt that *Heli-Coil* was a departure from the objective approach in that the Third Circuit found that no actual profit had been realized from the "sale" of the debentures,[47] the appellate court did use the objective rhetoric in defining the conversion of debentures as a "sale" and in holding the defendant liable for the profits accruing from the second transaction.[48]

Even if it is assumed that the possibility of abuse existed in *Park & Tilford*, *Hodgkinson* and *Heli-Coil*, the rationale supporting the decisions represented a very real danger that 16(b) would come to be used to trap the unwary corporate insider as much as to control abusive practices. If the strict "objective" reading of the statute were to continue, the insider who had acquired his stock via complex transfers which in no way permitted reliance on inside information would find himself forced to give up his profits. Perhaps in recognition of this potential hardship, appellate courts began, in 1958, to follow the subjective approach.

The subjective approach stresses that the purpose of 16(b) as indicated in its preamble[49] is the prevention of unfair use of information. This approach provides for a factual analysis of the transaction in question to determine whether the transaction in any way allows the unfair insider trading that 16(b) was designed to prevent.[50] The approach is not totally subjective, however, because once the court finds that there exists any possibility of use of inside information, neither

[45] 222 F. Supp. 831, 834 (D.N.J. 1963).

[46] 352 F.2d at 167-69.

[47] Lowenfels, supra note 34, at 52.

[48] In defining the conversion of the debentures into the common as a "sale" of the debentures, the court concluded that "Congress intended the test to be an entirely objective one and that § 16(b) does set up a 'rule of thumb' . . ." and the "conversion of the debentures by Webster was a sale of the debentures and a purchase of the common stock." 352 F.2d at 165-67. However, the court went on to exclude the profits of the purchase and "sale" of the debentures from 16(b) liability because no profits were realized at the time of the conversion. Id. at 167-68.

[49] The preamble refers to "the purpose of preventing the unfair use of information which may have been obtained by such beneficial owner, director or officer . . . ." 15 U.S.C. § 78p(b) (1970).

[50] Blau v. Lamb, 363 F.2d 507, 518 (2d Cir. 1966), cert. denied, 385 U.S. 1002 (1967).

the insider's intent nor his actual use of the inside information is considered relevant.[51] Hence the subjective test is consistent with the statute insofar as intent and use are deemed irrelevant, as the legislature intended.[52] It is also arguable that the standard of "possibility of abuse" is consistent with the legislative intention to provide an automatic, mechanical test. It must be admitted, however, that the "possibility of abuse" test is not the same as the "transaction" test that the statutory language seems to provide.[53] The problem is that the statute does not say whether the possibility of abuse is a permissible standard or not. Arguably the language of the statute punishes transactions effected within a certain time frame with no further questions asked. For that reason the subjective approach has been criticized as being contrary to the automatic approach Congress intended,[54] as well as being indefinite and unpredictable.[55]

The criticism that the subjective approach is not automatic is subject to the counter-argument that the possibility of abuse test may properly be used at least in those situations when it is impossible to apply the purely automatic objective test in a purely automatic way: when, for example, courts must debate whether the transaction in question is one that Congress intended to prohibit under 16(b). It is precisely this kind of transaction that is involved in the cases where either the subjective or the objective rationale must be applied; hence the former approach may be a valid means of resolving a problem not susceptible to a purely mechanical application of the literal words of the statute. It may be argued further that even where the transactions clearly come under the literal wording of the statute, the statutory purpose to curtail abuse of insider information should still be considered. Where there is no possibility of such abuse, there should be no punishment, no matter what the nature of the transaction. In any event, the subjective approach has seemed, to many, more rational and fair than the objective approach, and certainly has gained favor with courts[56] and commentators[57] alike.

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51 Newmark v. RKO General, Inc., 425 F.2d 348, 362 (2d Cir. 1970), affirming 305 F. Supp. 310 (S.D.N.Y. 1969).

52 Section 16(b) does not require proof of use of inside information as a prerequisite to recovery. 15 U.S.C. § 78p(b) (1970), quoted in note 6 supra. See also text at note 21 supra.

53 15 U.S.C. § 78p(b) (1970), quoted in note 6 supra.

54 Hamilton, Convertible Securities and Section 16(b): The End of an Era, 44 Texas L. Rev. 1447, 1454 (1966).

55 Note, supra note 31, at 1040.

56 Cases that have followed this approach are: Abrams v. Occidental Petroleum Corp., 323 F. Supp. 570 (S.D.N.Y. 1970), rev'd, 450 F.2d 157 (2d Cir. 1971); Newmark v. RKO General, Inc., 305 F. Supp. 310 (S.D.N.Y. 1969), aff'd, 425 F.2d 348 (2d Cir. 1970); Blau v. Lamb, 242 F. Supp. 151 (S.D.N.Y. 1965), rev'd, 363 F.2d 507 (2d Cir. 1966), cert. denied, 385 U.S. 1002 (1967); Petteys v. Butler, 367 F.2d 528 (8th Cir. 1966), cert. denied, 385 U.S. 1006 (1967); Blau v. Max Factor & Co., 342 F.2d 304 (9th Cir.), cert. denied, 382 U.S. 892 (1965); Roberts v. Eaton, 212 F.2d 82 (2d Cir.), cert. denied, 348 U.S. 827 (1954).

57 2 Loss, supra note 4, at 1069-70; Lowenfels, supra note 34, at 57-64; Note, supra note 31, at 1039-45.

Starting with *Ferraiolo v. Newman*[58] in 1958, the subjective approach has been the prevailing view in appellate decisions.[59] The facts in *Ferraiolo* are similar to those in *Park & Tilford*: the defendant acquired shares of convertible preferred stock in Ashland Oil & Refining Co. and at the same time became a director of the company. Three years later he converted these shares into Ashland common and within six months he sold some of the common at a profit. Also significant were the facts that the convertibility of the shares was protected against dilution; that at the time the preferred shares were called for redemption the preferred and common were both selling at the same price; and that the defendant had no control over Ashland and could not pick the time for redemption.

After discussing the legislative history of 16(b), Judge (now Justice) Stewart enunciated the standard: "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)."[60] The court, after reviewing the facts, held that the transaction did not lend itself to the possibility of insider abuse and therefore the conversion of the preferred shares was not a "purchase." The case was distinguished from *Park & Tilford* in that this transaction was an involuntary one because the defendant could not control the time of redemption and because he would have lost nine dollars a share if he did not convert. Also, the preferred and common were economic equivalents in *Ferraiolo*, whereas in *Park & Tilford* the common was worth more than the non-marketable preferred.

The vast majority of cases since *Ferraiolo* have adopted the subjective rationale. In *Blau v. Lamb*,[61] the defendant was an officer and director of Air-Way Industries and Edward Lamb Enterprises. Lamb received convertible preferred stock of Air-Way pursuant to a merger between Air-Way and Lamb Industries, a corporation almost totally owned by the Lamb family. Within six months after receiving the Air-Way preferred, Lamb converted the stock into Air-Way common as part of a preconceived plan to increase his voting control of Air-Way. The plaintiff contended that the conversion was a "sale" of the preferred to be matched with the earlier "purchase." The district court held for the plaintiff,[62] but the Second Circuit reversed,[63] adopting the subjective approach and stating that "the application of Section 16(b) depends upon whether the transaction in question could tend to accomplish what the section was designed to prevent."[64] The court rejected the argument that Congress had removed from the courts the power to decide that 16(b) should not apply to a transaction that could

58 259 F.2d 342 (6th Cir. 1958), cert. denied, 359 U.S. 927 (1959).
59 See note 56 supra.
60 259 F.2d at 345.
61 242 F. Supp. 151 (S.D.N.Y. 1965), rev'd, 363 F.2d 507 (2d Cir. 1966).
62 242 F. Supp. at 157.
63 363 F.2d 507 (2d Cir. 1966).
64 Id. at 519.

not possibly do the evil the legislature wished to remedy. The court stated:

> [T]he theory of regulation underlying Section 16(b)'s regulatory mechanism provides a sufficient reason for refusing to examine the details of transactions once it has been determined that they might possibly have served as vehicles for unfair insider trading. But it does not supply an equally sufficient reason for applying Section 16(b) in this same automatic fashion when a substantial question is raised whether a certain conversion transaction permits a possibility of insider abuse.[65]

The court then went on to decide that the transaction in question did not lend itself to insider speculation.

Petteys v. Butler,[66] decided in 1966, is an important decision because it was decided by the same circuit court that later decided *Emerson.* In *Petteys*, two directors who were noncontrolling stock holders of Northwest Airlines converted their preferred stock pursuant to a call for redemption of the preferred, and within six months sold the common at a profit. The Eighth Circuit held that the conversion was not a "purchase" of the common.[67] The court found the case to be factually similar to *Ferraiolo* and relied on the rationale of that case. The *Petteys* court stated:

> [T]he rule has been clearly established . . . that each case must be examined on its own particular facts. If, from an examination of the particular facts, a transaction is of a kind that can possibly lend itself to the speculation encompassed by § 16(b) and falls within the broad definitions of "purchase" and "sale," it will be so defined. However, if an examination of the facts indicates that there is no possibility of abuse, there is no need to apply a § 16(b) label to the transaction.[68]

The court found no possibility of abuse for basically the same reasons as in *Ferraiolo*: involuntariness of the transaction and the economic equivalence of the stocks.

In *Newmark v. RKO General, Inc.*,[69] the court used the subjective approach to hold certain transactions subject to 16(b) liability. The defendant owned a fifty-six percent controlling interest in Frontier Airlines, Inc. In April 1967, Frontier and Central Airlines agreed to merge pursuant to a stock exchange plan. On May 4, RKO contracted with Central shareholders to buy forty-nine percent of Central shares at $8.50 per share, the terms of the contract obligating Central share-

65 Id.
66 367 F.2d 528 (8th Cir. 1966), cert. denied, 385 U.S. 1006 (1967).
67 Id. at 537.
68 Id. at 535.
69 425 F.2d 348 (2d Cir. 1970).

holders to vote in favor of the merger. On September 18 the purchases were executed and on October 1, 1967, RKO exchanged its Central stock for Frontier stock pursuant to the merger plan. Plaintiff contended that the exchange of Central shares was a "sale" to be matched with their prior purchase. The court, applying the subjective test, stated that the "threshold issue . . . is whether the purchase and subsequent exchange of Central shares lent itself to the type of speculative abuse which section 16(b) was designed to prevent."[70] The court answered this question in the affirmative basing its response on RKO's knowledge of the impending merger, the subsequent predictable price rise of both stocks, and the purchase of the Central stock at a fixed price, which was bound to be lower than the value of the stocks at the time of merger.[71] Without further inquiry as to actual speculative abuse, the court held the transaction subject to 16(b) liability.

Abrams v. Occidental Petroleum Corp.[72] represents the last federal appellate application of the subjective test that occurred before the *Emerson* decision. By May 10, 1967, Occidental had acquired more than ten percent of Kern County Land Company in an attempt to take over Kern. In a defensive maneuver, Kern announced a agreement to merge with Tenneco, Inc., by means of a stock exchange plan. When this merger was closed on August 30, Occidental became entitled to Tenneco stock in return for its Kern, although the actual transfer did not take place until December 11. In the meantime, on June 2, Occidental had agreed with Tenneco to issue options to the latter for the cash purchase of Tenneco's stock that Occidental would receive pursuant to the Kern-Tenneco merger. On December 11, 1967, after Occidental received the Tenneco shares, this option was exercised. Shortly thereafter, plaintiff asserted that Occidental was subject to 16(b) liability on the grounds that Occidental had "sold" its Kern Shares on August 30, when it became irrevocably entitled to the Tenneco stock.

Judge Friendly, speaking for the court, rejected the *Park & Tilford* mechanistic approach and instead stated that the court would look to the question of whether the receipt of securities of another company in a transaction which the insider did not arrange could have lent itself to speculative abuse.[73] The court then decided that Occidental could have had no knowledge that Kern would defensively merge and that there was no possibility of speculative abuse merely because Occidental failed either to make a higher offer or to attempt to block the merger. A major factor influencing this decision was the court's reluctance to let Kern use Occidental's possible 16(b) liability to induce Tenneco to merge.[74] This inducement would exist since the potential liability would be viewed as a potential asset of the merged corporation.

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70 Id. at 353.
71 Id. at 353-54.
72 450 F.2d 157 (2d Cir. 1971).
73 Id. at 162.
74 Id. at 163-64.

Then, a year or so after *Occidental Petroleum,* the *Emerson* case brought a new dimension to the subjective/objective controversy by requiring a decision as to 16(b)'s applicability to two-step selldown transactions. Because both the Eighth Circuit and the Supreme Court looked to the objective language of 16(b) and refused to apply the possibility of abuse test, it might well be concluded that the objective rationale had not only been revived but had emerged victorious over the subjective rationale. However, in light of (1) the strong trend to apply the subjective approach, (2) the fact that Justice Stewart, the author of the *Emerson* opinion, had first articulated the subjective rationale in *Ferraiolo,* and (3) the Eighth Circuit's strong endorsement of this approach in *Petteys,* it is submitted that in *Emerson* neither the Eighth Circuit nor the Supreme Court meant to reject the subjective approach for all 16(b) transactions.[75]

A brief review of the facts of *Emerson* reveals that they are apparently very similar to those of the *Occidental Petroleum* case. Emerson attempted to merge with Dodge but was outflanked by Dodge's defensive merger with Reliance. Instead of accepting Reliance stock at merger time and then selling it, Emerson chose to divest itself of its Dodge holdings immediately. Both Occidental and Emerson were outflanked tender offerors who were trying to make the best out of a bad situation. On these facts it is difficult to ascertain why the Supreme Court chose not to apply the subjective test in *Emerson* when the Second Circuit had applied it in *Occidental.*

A clue to what the Supreme Court had in mind may be found in the language of the *Emerson* opinion. The Court said that "*where alternative constructions of the terms of § 16(b) are possible,* those terms are to be given the construction that best serves the congressional purpose of curbing short-swing speculation by corporate insiders."[76] This language is similar to the statement in *Ferraiolo* by Justice Stewart (then a judge with the Sixth Circuit) that "[e]very transaction *which can be reasonably 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)."[77]

Then in a footnote the *Emerson* opinion stated: "In interpreting the terms of 'purchase' and 'sale,' courts have properly asked whether the particular type of transaction involved is one that gives rise to speculative abuse."[78] Paradoxically, the Court then moved away from this initial endorsement of the subjective approach and said in effect that to treat the two sales as one, on the ground that Emerson intended

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[75] Note, 60 Geo. L.J. 815, 821 (1972), suggests that the Eighth Circuit's discussion of *Emerson* is an across-the-board endorsement of the objective approach to 16(b) problems.

[76] 404 U.S. 418, 424 (1972) (emphasis added).

[77] Ferraiolo v. Newman, 259 F.2d 342, 345 (6th Cir. 1958) (emphasis added).

[78] 404 U.S. at 424 n.4.

to avoid liability, would be contrary to the congressional desire that the statute be applied mechanically.[79]

It is submitted that a major concern of the Supreme Court was the fact that the cash sale of stock did not present a case which required a construction of the term "purchase" or "sale." If the Court were to apply the subjective approach to the second transaction, logically it would have to apply it to the first sale, probably exempting the first sale from liability, if the Court should find no possibility of use of inside information.[80] To exempt either sale on the basis that it was not a *sale* within the meaning of 16(b) would require a clear departure from statutory language—a departure that the Court was not prepared to take. The statute is concerned with sales; unlike mergers, options or exchanges of stock, the transactions involved in *Emerson* were clearly sales. Were the Court to have utilized a subjective rationale, it would have been forced, in effect, to construe a term that did not call for construction. Thus, to avoid having to construe the term "sale" in this situation, the Court simply applied a literal interpretation of the statute. Since Emerson was not a ten percent holder at the time of the second sale, the Court reasoned, the second sale should not precipitate liability. The Court suggested that this freedom from liability constitutes a loophole but maintains that 16(b) was not meant to reach every insider transaction;[81] if Congress views this two-step selldown process as an evil, it can close the loophole by amending the statute.[82]

It can be argued, however, that the Court should have looked to the possibility of use of inside information.[83] Merely because Emerson's transactions were cash sales does not mean that they could not be defined in accordance with the purpose of 16(b), which is to prevent unfair use of inside information for speculative profit by insiders: that is, the Court could have insisted on a limiting definition of the term "sales" that would exclude those sales clearly outside the ambit of the congressional concern. Had the Court adopted this approach, it might have been required to deny recovery in the first as well as the second sale, but apparently this would have been an equitable result in this

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79 Id. at 424-25.

80 In advocating the application of the subjective approach to the *Emerson* situation, one author suggests that since there was no possibility of use of inside information in either the first or second sale, neither should be subject to liability. Note, supra note 75, at 822.

81 404 U.S. at 422-23.

82 "If a 'two-step' sale of a 10% owner's holdings within six months of purchase is thought to give rise to the kind of evil that Congress sought to correct through § 16(b), those transactions can be more effectively deterred by an amendment to the statute . . . ." Id. at 425.

83 In an unusual application of the subjective approach, the dissent in *Emerson* advocates that the court look to the possibility of abuse and then concludes, without explaining, that there existed a possibility of abuse. In effect, the dissent would use the subjective approach to *restore* the arbitrary aspect of 16(b), while most recent courts have used it to soften the harshness of 16(b). Id. at 427-42 (Douglas, J., dissenting).

case.[84] At the same time the Court could have laid the foundation for denying recovery in future cases where a two-step selldown might be based on inside information. Thus the Court could itself have closed the loophole, instead of calling on Congress to make an amendment whenever a new type of transaction does not seem to fall within the exact wording of the statute.[85]

The *Emerson* decision, while adopting a literal interpretation of 16(b), probably has a more limited scope than at first appears. As far as precedential value is concerned, it should not be read as a complete rejection of the subjective test. Rather, *Emerson* seems to stand for the proposition that the subjective test is not to be used in cases where the transaction in question is clearly a cash purchase or sale. However, because this limitation is not expressly stated, the opinion is confusing, especially to those who are looking for an endorsement of either the subjective or objective test from the Court. Furthermore, even the limited proposition the case does seem to stand for is subject to question. It would seem proper for the Court to define even cash purchases and sales in terms of the congressional purpose and so put transactions such as those in *Emerson* to the same test as transactions that obviously require definition of the term sale, such as mergers. If there is no possibility that the cash purchase or sale could arise from or lead to use of insider information, there should be no liability.

Emerson must also be criticized for being overly broad in allowing two-step selldown procedures even though future two-step cases, unlike *Emerson*, may clearly involve speculative abuse. A resort to the language and spirit of the subjective approach would have precluded this result.

WALTER C. SPIEGEL

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[84] On May 27, 1967, after Emerson had embarked on a tender offer plan, Dodge filed suit to enjoin Emerson from accepting tenders of Dodge stock. The federal district court, in an unreported opinion, denied the injunction, finding that Emerson possessed no inside information about Dodge. 434 F.2d at 920 n.5. After acquiring the 13.2 percent interest in Dodge, Emerson once again proposed a merger. The Dodge board of directors rejected the proposal and refused to allow Emerson to examine the stockholder list. Id. at 920 n.6. These two factors, highlighting the strained relation between Dodge and Emerson, make it highly unlikely that Emerson had any inside information either at the time of the purchase or the time of the sale of the Dodge common.

[85] As suggested in Lowenfels, Section 16(b): A New Trend in Regulating Insider Trading, 54 Cornell L. Rev. 45, 64 (1968), it may be impractical to ask a busy Congress to make these amendments:

> Congress has many more pressing and important problems than the fate of one comparatively obscure provision of the federal securities laws. Rather, the solution would seem to lie with the federal courts . . . . The development and extension of the subjective interpretation of section 16(b) . . . [is] the most practical solution to what has in reality become a statutory anachronism.