Boston College Law Review

Volume 15
Issue 1 *Number 1*

Article 7

11-1-1973

Securities -- Insiders' Liability Under Section 16(b) of the Securities Exchange Act for Stock Transfer After Corporate Merger -- Kern County Land Co. v. Occidental Petroleum Corp.

John K. Olson

Follow this and additional works at: http://lawdigitalcommons.bc.edu/bclr

Part of the Securities Law Commons

Recommended Citation
John K. Olson, *Securities -- Insiders' Liability Under Section 16(b) of the Securities Exchange Act for Stock Transfer After Corporate Merger -- Kern County Land Co. v. Occidental Petroleum Corp.*, 15 B.C.L. Rev. 149 (1973), http://lawdigitalcommons.bc.edu/bclr/vol15/iss1/7

This Casenotes is brought to you for free and open access by the Law Journals at Digital Commons @ Boston College Law School. It has been accepted for inclusion in Boston College Law Review by an authorized editor of Digital Commons @ Boston College Law School. For more information, please contact nick.szydlowski@bc.edu.

affirmatively to clarify the relationship between state trade secret law and federal patent policy.[61] In light of this, it is submitted that a definitive determination by the Supreme Court of the permissible parameters of state trade secret law in light of the federal patent law is necessary to alleviate the uncertainty under which trade secret-dependent industries now operate.[62] Since the Second Circuit's approach—retention of state trade secret law and the protection it affords—appears to be most reasonable and responsive to industrial realities, it is further submitted that such determination should be made in favor of recognizing that vigorous state trade secret law can coexist with federal patent law and is compatible with both the constitutional patent policy and the exercise of the patent power by Congress.

RANDOLPH H. ELKINS

Securities—Insiders' Liability Under Section 16(b) of the Securities Exchange Act for Stock Transfer After Corporate Merger—*Kern County Land Co. v. Occidental Petroleum Corp.*[1]—On May 8, 1967, Occidental Petroleum Corporation (Occidental) announced a tender offer to purchase 500,000 shares of the stock of Kern County Land Company (Old Kern).[2] The tender offer expired June 8, 1967. Occidental offered to buy at a price roughly one-third higher than the current market price.[3] Within two days Occidental had received more than 500,000 shares. It extended its offer, and by June 30 owned 887,549 shares.[4] In the course of this period, Occidental

[61] A recent Senate bill that would have expressly rejected federal preemption of trade secret law failed in committee. See R. Milgrim, supra note 8, § 7.08, at 7-70.8(2) n.56.26, 7-70.8(17) n.56.28 for background. On the other hand, Congress has not seen fit, in the present laws or elsewhere, to assert such preemption, and in fact has recognized the need for trade secret protection in numerous acts setting guidelines for their handling by administrative bodies. See R. Milgrim, supra, ch. 6 for an extensive discussion of the federal acts referring to trade secrets.

[62] The Supreme Court recently granted certiorari. 94 S. Ct. 70, 42 U.S.L.W. 3194 (U.S. Oct. 9, 1973) (No. 187).

[1] 411 U.S. 582 (1973).

[2] Occidental had previously attempted a merger with Old Kern, but had been rejected by Kern's board. Occidental made the tender bid in the hope that ownership of a large block of stock would make Old Kern amenable to merger. Abrams v. Occidental Petroleum Corp., 323 F. Supp. 570, 572-74 (S.D.N.Y. 1970).

After the reorganization which followed, Kern County Land Co. became known as 600 California Corp. until its dissolution on Oct. 6, 1967. 411 U.S. at 584 n.2. Kern County Land Co. (New Kern), a Delaware corporation, is a wholly owned subsidiary of Tenneco Corp., itself a wholly owned subsidiary of Tenneco, Inc. Id. at 586 & n.10.

[3] Old Kern closed at 63⅝ on the last trading day before the tender offer; Occidental offered $83.50 plus $1.50 brokerage payment. 411 U.S. at 584, 585 n.5.

[4] This figure included 1900 shares which Occidental had purchased on the open market in April 1967. 323 F. Supp. at 573-74. "Beneficial ownership" status was not asserted as to those shares. 411 U.S. at 585 n.7.

became a "beneficial owner" under section 16(b) of the Securities Exchange Act of 1934[5] (*i.e.*, owner of ten percent of the outstanding shares) of Old Kern and therefore became liable for any profits on trading activity in Old Kern which might occur before Occidental had held these shares for six months.

Old Kern's management twice asked its stockholders to refrain from selling to Occidental[6] and, feeling that the Occidental offer undervalued its stock, entered into negotiations with Tenneco. It announced a "defensive" merger[7] with the conglomerate on May 19. The merger provided for conversion on a one-for-one basis of Old Kern shares for a new Tenneco preference issue,[8] which was freely convertible into 3.6 shares of Tenneco common stock.[9] That same day, Occidental estimated the new Tenneco preference to be worth $105 per share.[10]

Worried by its significant minority position in Tenneco resulting from its purchase of Old Kern shares, Occidental signed an agreement with Tenneco on June 2, 1967, whereby Tenneco took a refundable "call" option on Occidental's shares of Old Kern.[11] Occidental simultaneously sought promulgation from the SEC of a new rule, which Occidental termed "proposed Rule 16b-11." This rule would have provided an exemption from section 16(b) liability for corporations attempting takeover, where the takeover attempt had been foiled by a defensive merger, such as the Old Kern-Tenneco merger.[12] Occidental feared that the consummation of the Old

---

[5] 15 U.S.C. § 78p(b) (1970). For the text of § 16(b), see note 34 infra.

[6] Pleas to hold shares occurred once by mail when the original tender offer was made, and later by telegram when Occidental renewed its offer. 411 U.S. at 585.

[7] A defensive merger is accomplished when the company under attack, here Old Kern, agrees to merge with a corporation other than the one which is attempting takeover by means of its tender offer. See Schmults & Kelly, Cash Take-Over Bids—Defense Tactics, 23 Bus. Law. 115 (1967).

A company under seige by a tender offer may be willing to merge defensively for several reasons. Often, existing management can protect its employment position and policies through a negotiated merger but not in the unfriendly takeover situation. In the case of the Old Kern-Tenneco merger, price played a major role: Tenneco offered stock worth $105 for each share of Old Kern. This was $20 more per share than the Occidental tender bid. In addition, by offering a stock trade rather than a purchase for cash, Tenneco held out the inviting prospect of a ruling from the Internal Revenue Service characterizing the transaction as a tax-free exchange. This tax advantage, which was later realized, clearly could not accrue to the Occidental offering for cash. 411 U.S. at 586 n.11. For a discussion of tender offers in general, see E. Aranow & H. Einhorn, Tender Offers for Corporate Control (1973).

[8] This was not an issue of preferred stock, but a particularized issue designed solely to be convertible with Old Kern common stock on a one-for-one basis, and to be convertible into 3.6 shares of Tenneco common. 323 F. Supp. at 575.

[9] 411 U.S. at 586 n.11.

[10] Id. at 586.

[11] Id. at 587. Tenneco wished to rid itself of a potentially disruptive stockholder in Occidental. The option was operative only after Dec. 9, 1967.

[12] The SEC declined to promulgate "proposed Rule 16b-11," despite its grant of a formal hearing on Aug. 29, 1967. 323 F. Supp. at 577. Rule 16b-11, adopted in SEC Securities Exchange Act Release No. 8229 (Jan. 17, 1968), effective Feb. 2, 1968, 17 C.F.R.

Kern-Tenneco merger might constitute a "sale" of Occidental's Old Kern stock within the meaning of section 16(b).[13] Occidental also sought to delay the Old Kern-Tenneco merger beyond the six month statutory limit by inspiring a series of delaying suits by Old Kern shareholders.[14] These "oppressive and vexatious" suits, as the court termed them,[15] did not interfere with the merger plans. The merger was concluded on August 30, 1967, when Old Kern's assets were transferred to New Kern. At this time Occidental became irreversibly bound to accept Tenneco's new preference shares in return for its Old Kern common.[16]

Occidental delayed tendering its Old Kern stock until December 11, 1967, but then received its Tenneco preference shares. Acting under the June 2 option agreement, Tenneco immediately redeemed the shares for a total payment of $93,905,415. Occidental also received dividend payments totalling $1,793,439.22.[17]

New Kern and various Tenneco stockholders' groups claimed for Tenneco the profits made by Occidental in the transaction in a suit brought in the Southern District of New York.[18] The district court found that the merger of Old Kern with Tenneco and the exchange of Tenneco preference stock for Old Kern common constituted a "sale" within the meaning of section 16(b), and ordered Occidental as a beneficial owner of Old Kern to disgorge the profits on the sale, an amount which totalled $1,712,980.[19] The court reasoned that Occidental's voluntary acquisition of more than 10 percent of Old Kern's common implied a voluntary acceptance of all obligations and burdens of a statutory insider.[20] The district court, in a supplementary opinion, awarded the dividends to New Kern.[21]

On appeal, the Second Circuit reversed and granted summary judgment for Occidental.[22] The court rejected both of New Kern's

---

§ 240.16b-11(1973), deals with the sale of subscription rights and has no relation to Occidental's proposal of June-Sept. 1967.

[13] This was one of the theories before the district court in *Abrams*. The court held a sale did occur. 323 F. Supp. at 580.

[14] The stockholder group of plaintiffs

> has been determined to keep multiforum litigation going constantly over a widespread area for the purpose of delaying the consummation of the plan, if not to defeat it, knowing all the time that they had no chance of winning the litigation.

600 California Corp. v. Harjean Co., 284 F. Supp. 843, 856 (N.D. Tex. 1968).

[15] Id. at 861.

[16] 411 U.S. at 589.

[17] Id.

[18] Abrams v. Occidental Petroleum Corp., 323 F. Supp. 570, 579 (1972).

[19] Id. at 580.

[20] Id. at 582.

[21] Id.

[22] Abrams v. Occidental Petroleum Corp., 450 F.2d 157, 165 (2d Cir. 1971). The grant of summary judgment was made despite the fact that Occidental had not requested summary judgment below.

Justice Douglas, in his dissent on appeal to the Supreme Court, complains about this direct entry of summary judgment for Occidental by the Second Circuit:

contentions: that Occidental had "sold" its shares of Old Kern on August 30 when it became irrevocably entitled to Tenneco preference stock; and that the option agreement of June 2 had constituted a "sale" within the meaning of section 16(b).[23] The court, speaking through Judge Friendly, found that the "sale" occurred upon exercise of the June 2 option.[24] This took place on December 11. Expanding its reasoning to focus on the delineated concerns of the Securities Exchange Act of 1934,[25] the Second Circuit reasoned that Occidental at no time had any information concerning Old Kern which could have led to speculative abuse.[26] Occidental had no possible access to inside information despite the statutory inferences raised by its beneficial owner status; it did not know that Old Kern's management would be able to negotiate a merger realizing prices $20 per share higher than Occidental's offer and free from capital gains tax.[27]

The Supreme Court granted certiorari[28] to consider whether a section 16(b) "sale" occurs when the target of a tender offer defends itself by merging with a third company and the tender offeror then exchanges his stock for stock in the third company, at the same time granting a purchase option on that stock which may be exercised only after the six month period has expired.[29] In a six to three decision,[30] the Court HELD: when a beneficial owner of ten percent or more of the stock in a corporation is incapable of possessing any inside information concerning the corporation and is therefore unable to engage in the kind of speculative abuse which section 16(b) was designed to prevent, then neither the granting of an option to purchase such stock, nor the fact that such beneficial owner becomes irrevocably bound to exchange his shares for those in another corpo-

---

> Even if it can be justified in the most limited circumstances—for example, where the record below left no doubt whatsoever that the nonmoving party was entitled to summary judgment as a matter of law—this is not such a case.

411 U.S. at 614 (dissenting opinion). The majority opinion is silent on the matter.

[23] 450 F.2d at 161-62.

[24] This event had been fixed under the terms of the option contract to occur after Dec. 9, 1967, six months and one day after Occidental's last contemplated acquisition of Old Kern common. Id. at 160.

[25] 15 U.S.C. §§ 78a-*lll* (1970). See text at note 34 infra.

[26] 450 F.2d at 165. New Kern argued that Tenneco had been pressured by Occidental, who was able to use its large holdings to extort a high redemption price from Tenneco. Judge Friendly rejected this argument, noting that the option price of $105 was precisely what Occidental's advisor, Lehman Brothers, had said the preference issue was worth, and that the option was merely

> a straight-forward business arrangement between one company that found itself in the undesired position of becoming "locked in" as a large minority stockholder and a second company that was eager to remove the threat thus imposed, if economic circumstances permitted.

Id. (footnote omitted).

[27] Id. at 163.

[28] 405 U.S. 1064 (1972).

[29] 411 U.S. at 584.

[30] Id. at 582.

ration, constitutes a "sale" of those shares within the meaning of section 16(b) of the Securities Exchange Act of 1934.[31]

Occidental provides clarification to the 1972 case of *Reliance Electric Co. v. Emerson Electric Co.*[32] That decision appeared on its face to approve an "objective" approach to section 16(b) litigation over the "subjective" approach which had been dominant in the lower courts for some time.[33] In *Occidental* the Supreme Court provided its endorsement of the subjective approach. This note will describe the function of section 16(b) and will then trace the development of case law concerning the statute culminating in *Occidental.* It will be submitted that *Reliance* and *Occidental* are both good law and must be read together; that despite the narrowness of the actual holding in *Occidental,* the primary theoretical problem concerning section 16(b) has been resolved by this case; and that future litigation will focus on questions of fact rather than questions of law.

Section 16(b) of the Securities Exchange Act of 1934[34] was enacted to prevent unfair use of inside information by statutory insiders.[35] To that end, corporate insiders are required to surrender to the issuing corporation any profits realized from the purchase and sale, or sale and purchase, of an equity security of such issuer within any period of less than six months. Congress included the section in the New Deal regulation of the stock markets because of conspicu-

---

[31] Id. at 599-600.

[32] 404 U.S. 418 (1972). For a discussion of the interpretive problems surrounding *Emerson,* see, e.g., Note, 14 B.C. Ind. & Com. L. Rev. 560 (1973); Note, *Reliance Electric* and 16(b) Litigation: A Return to the Objective Approach?, 58 Va. L. Rev. 907 (1972).

[33] See text following note 45 infra.

[34] 15 U.S.C. § 78p(b) (1970). Section 16 provides in part:

§ 16(b). 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 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.

[35] These are defined as a "beneficial owner, director, or officer." 15 U.S.C. § 78p(b) (1970). The term "beneficial owner" refers to one who owns "more than 10 per centum of any class of any equity security (other than an exempted security) which is registered pursuant to [§ 12(g) of the Exchange Act] . . . ." 15 U.S.C. § 78p(a) (1970).

ous evidence that insiders were able to take advantage of information not available to the general investing public.[36] In the "garden-variety"[37] purchase and sale (or sale and purchase) within six months, section 16(b) acts as a "crude rule of thumb"[38] to return more or less mechanically any profits made by an insider. Major problems in interpreting section 16(b) have arisen from the fact that the statutory definitions of "purchase" and "sale" are broad, imprecise and ultimately tautological.[39]

The early cases presented few interpretive problems. In *Smolowe v. Delendo Corp.*,[40] the defendant-directors of Oldetyme Distillers Corporation bought and sold for cash large blocks of Oldetyme common stock within a six month period. The directors were held liable, although no showing was made that inside information had been misused.[41] This is perhaps the simplest example of the 16(b) situation and consequently is most prone to mechanistic or objective application of 16(b) sanctions.

Fact patterns after *Smolowe* became increasingly complex, probably as a result of corporate attempts to avoid liability. Transactions were frequently of an "unorthodox"[42] variety; they involved such noncash transfers as the exercise of options and warrants to purchase stock, conversions of convertible securities, and transactions in stock pursuant to mergers, reclassifications or reorganizations. For example, in *Park & Tilford, Inc. v. Schulte*,[43] the defendant-directors voluntarily converted their shares of preferred stock into its conversion common and, within six months, sold the common. At the time of conversion, the common was experiencing a "spectacular rise"[44] due to a rumor that the corporation, controlled by the defendants, was about to pay a dividend in liquor. The

[36] Included in this exploitation were the "betrayal of . . . fiduciary duties by directors and officers of corporations" and the "unscrupulous employment of inside information by large stockholders." Senate Comm. on Banking and Currency, Stock Exchange Practices, S. Rep. No. 1455, 73d Cong., 2d Sess. 55 (1934). Also included were manipulations of market prices by artificial means by such corporate insiders as the President of the New York Stock Exchange, the chief executive officer of the Chase National Bank and the Chairman of the Board of the National City Bank. See generally Reliance Elec. Co. v. Emerson Elec. Co., 404 U.S. 418, 428-31 (1972) (dissenting opinion).

[37] 450 F.2d at 162.

[38] Statement of Thomas G. Corcoran, Administration spokesman, in Hearings on S.R. 84 Before the Senate Comm. on Banking and Currency, 73d Cong., 2d Sess. 6557 (1934).

[39] The applicable definitions are: "The terms 'buy' and 'purchase' include any contract to buy, purchase, or otherwise acquire." 15 U.S.C. § 78c(a)(13) (1970). "The terms 'sale' and 'sell' each include any contract to sell or otherwise dispose of." 15 U.S.C. § 78c(a)(14) (1970).

[40] 136 F.2d 231 (2d Cir.), cert. denied, 320 U.S. 751 (1943).

[41] 136 F.2d at 236. There is considerable belief that Rule 10b-5 is a better instrument to control insider speculation in unorthodox "purchase and sale" situations than is § 16(b). Rule 10b-5, 17 C.F.R. § 240.10b-5 (1973), which governs actual misuse of inside information, was not adopted until 1948. Its present form was adopted in 1951. See, e.g., Lowenfels, Section 16(b): A New Trend in Regulating Insider Trading, 54 Cornell L. Rev. 45 (1968).

[42] The term is from 2 L. Loss, Securities Regulation 1069 (2d ed. 1961).

[43] 160 F.2d 984 (2d Cir. 1947).

[44] Id. at 986.

Second Circuit declared that this conversion was voluntary, and was therefore a "purchase" of the common stock, and that section 16(b) liability therefore accrued.[45]

The test which Judge Clark laid down in his opinion in *Park & Tilford* was a mechanical one: "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."[46]

This mechanical test is easy to apply in a context like that of *Smolowe,* where there is little question that a "purchase and sale" has taken place: the transactions in *Smolowe* were for cash. For this reason, cash transactions—orthodox "purchases and sales"—are rarely litigated under section 16(b).[47] The *Park & Tilford* fact situation, however, presents far more difficult questions. The Second Circuit first recognized that the unorthodox transactions test could present fact problems when it decided *Roberts v. Eaton.*[48] In *Eaton,* the Eaton family, owners of 45.9 percent of the outstanding shares of $5 par value common stock of Old Town Corporation, engineered the reclassification of the outstanding shares of the stock into an equal number of shares of $1 par value common and $7 par value preferred. This reclassification, which increased marketability, was approved by 78 percent of the shareholders and was made in well-publicized contemplation of the retirement of the Eaton family from the business. Two months after reclassification, the Eatons liquidated their holdings.[49] The Second Circuit declined to follow the rule it had established in *Park & Tilford,* which would have required finding that the Eatons had "acquired" the new $1 par value common and $7 par value preferred, and had therefore "purchased" it. Instead, the court, again speaking through Judge Clark, applied a "subjective" test and held that "[t]he reclassification at bar could not possibly lend itself to the speculation encompassed in § 16(b). This being so, it was not a 'purchase'. . . ."[50]

The facts in *Park & Tilford* and *Eaton* exemplify the increasing complexity of post-*Smolowe* section 16(b) litigation, which has focused in the last twenty years more on unorthodox transactions than upon orthodox purchases and sales for cash. Most courts,[51] con-

---

[45] Id. at 987-88.

[46] Id. at 987.

[47] The only recent exception is Reliance Elec. Co. v. Emerson Elec. Co., 404 U.S. 418 (1972).

[48] 212 F.2d 82 (2d Cir. 1954).

[49] Id. at 83.

[50] Id. at 86.

[51] The only recent exception is the Third Circuit, which ruled en banc in Heli-Coil v. Webster, 352 F.2d 156 (3d Cir. 1965), that the conversion by a corporate officer of debentures into common stock and the subsequent sale of the common stock within six months was a "purchase and sale" within the meaning of § 16(b). The Third Circuit, concluding that "Congress intended the test to be an entirely objective one," id. at 165, adopted the test of

fronted with unorthodox transactions, have adopted the subjective approach to such transactions. The standard formulation of the subjective test was enunciated by Judge, now Mr. Justice, Stewart[52] in 1958 in *Ferraiolo v. Newman.*[53] Speaking for the Sixth Circuit and adopting the test recommended eight years before in the Yale Law Journal,[54] Judge Stewart said that "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)."[55]

Using this test, the court found that the conversion by a non-active director of Ashland Oil of his long-held shares of preferred stock into common, in order to avoid a $9 per share loss, followed by the sale of the common, did not constitute a "purchase and sale" within the meaning of section 16(b). The court emphasized that "[a]ll of the preferred shareholders were treated alike; full disclosure was made to them; the conversion worked no material change in the proportional equity ownership of Ashland."[56]

Accepting the reasoning of *Ferraiolo,* the Ninth Circuit in *Blau v. Max Factor & Co.*[57] suggested that an "initial inquiry"[58] into the purposes of section 16(b) must be made before the section is rigidly applied. In *Max Factor,* family members owning the corporation converted a portion of their holdings from Class A stock into common prior to the planned and publicized sale of the common. The Class A shares had been created thirteen years before, when Max Factor went public, to enable the formerly family-held corporation to pay maximum dividends to non-family stockholders while retaining the earnings of family stockholders for use in the business, concurrently avoiding additional tax liability for the family. The Class A shares were freely convertible into common. The court reasoned that the acquisition of the common by this means was not a purchase and that the application of section 16(b) to this unorthodox transaction would be contrary to the intent of the legislation,[59] and would constitute "purposeless harshness."[60]

Blau v. Lamb[61] involved similar stock conversion questions.

Park & Tilford and declined to consider whether speculative abuse was possible in the conversion. Id. at 173.

[52] It is particularly curious to note that Mr. Justice Stewart, although the formulator of what has become the classic subjective test, is among the dissenters in *Occidental,* concurring with Mr. Justice Douglas' opinion that the majority's "*ad hoc* analysis . . . undermines the congressional purpose." 411 U.S. at 605 (dissenting opinion).

[53] 259 F.2d 342 (6th Cir. 1958), cert. denied, 359 U.S. 927 (1959).

[54] Comment, The Scope of "Purchase and Sale" under Section 16(b) of the Exchange Act, 59 Yale L.J. 510, 513 (1950).

[55] 259 F.2d at 345.

[56] Id. at 346.

[57] 342 F.2d 304 (9th Cir. 1965).

[58] Id. at 307.

[59] Id. at 309.

[60] Id. at 307.

[61] 363 F.2d 507 (2d Cir. 1966).

That case concerned a complicated series of transactions in the convertible preferred and common stock of Air-Way Industries, Inc., which had been carried on by Edward Lamb Enterprises, Inc., and by Lamb personally in 1955.[62] The Second Circuit adopted a subjective standard for applying section 16(b) to this conversion transaction "which could not possibly serve as a vehicle for any of the abuses at which Section 16(b) was aimed."[63] The court upheld what it termed "a well-known rule of construction: *cessante ratione legis, cessat et ipsa lex,*"[64] and thereby invalidated an objective application of section 16(b) without a prior examination of the facts of the transaction.

A year later, the Eighth Circuit in *Petteys v. Butler*[65] decided another conversion case. The court adopted the subjective test and ruled that a non-controlling director's conversion of his convertible preferred shares into equivalent common shares was not a section 16(b) "purchase." The court ruled that directors were not accountable for profits made on the sale of the conversion security within six months, primarily because the corporation had ordered redemption on such terms that nearly all stockholders chose conversion and enjoyed the same benefits as the directors.[66]

Although there has been strong objection to adopting the subjective test,[67] the courts have increasingly done so, looking to the stated purpose of section 16(b)—"preventing the unfair use of information which may have been obtained by [an insider]"[68]—in determining the applicability of the section. The lower courts had largely concluded, with one notable exception,[69] that where there is no possibility of violation of this purpose by the transaction under consideration, section 16(b) should not be applied, since the opera-

---

[62] Id. at 512-13.

[63] Id. at 516.

[64] Id. Freely translated: If the reason for a law has ceased to exist, the law itself is inapplicable.

[65] 367 F.2d 528 (8th Cir. 1966). *Petteys* is notable for the dissent of Judge, now Mr. Justice, Blackmun, which typifies a reluctance in accepting the subjective test:

> [E]ither the statute means what it literally says or . . . it does not; . . . if Congress had intended to provide additional exceptions, it would have done so in clear language; and . . . the recognized purpose and aim of the statute are more consistently and protectively to be served if the statute is construed literally and objectively rather than non-literally and subjectively on a case-by-case basis. The latter inevitably is a weakening process.

Id. at 538 (dissenting opinion).

[66] Id. at 537. The question whether conversion of securities ever presents a § 16(b) liability has since been answered by the SEC in Rule 16b-9: the conversion of a convertible security into its conversion security is not comprehended within the purpose of § 16(b). 17 C.F.R. § 240.16b-9 (1973).

[67] See note 65 supra. However, like Mr. Justice Stewart (see note 52 supra), Mr. Justice Blackmun seems to have reversed himself since leaving the Eighth Circuit and joining the Supreme Court. Blackmun voted with the majority in *Occidental.*

[68] 15 U.S.C. § 78p(b) (1970). For full text, see note 34 supra.

[69] Heli-Coil Corp. v. Webster, 352 F.2d 156 (3d Cir. 1965).

tive portions of the section are only an enforcement procedure for the language in the statement of purpose.[70]

Analysis of the problem of section 16(b) liability has followed the following order when a court accepts the subjective test: (1) Is there an orthodox "purchase and sale" or "sale and purchase" of an equity security by a corporate insider within the statutory six months? (If so, liability clearly accrues.) (2) If there was no orthodox "purchase and sale" or "sale and purchase," was there a possibility for speculative abuse present in the transaction? (If not, liability does not accrue.) (3) If a possibility for speculative abuse was present in an unorthodox transaction, was there a "purchase and sale" or "sale and purchase" of an equity security by a corporate insider within the statutory six months? (If so, liability accrues just as in an orthodox sale for cash.) The courts which have adopted the subjective test have all considered the problem in the above order. The court in *Max Factor* posed as an "initial inquiry"[71] the question of speculative abuse in an unorthodox transaction; the court in *Newmark v. RKO General, Inc.*[72] raised as the "threshold issue" the question of whether speculative abuse was possible.[73]

It was against this background of a general trend toward the subjective approach[74] that the Supreme Court decided *Reliance Electric Co. v. Emerson Electric Co.*[75] in 1972. The facts of *Emerson* are at first glance similar to those in *Occidental,* and the two cases must be read together. Emerson acquired 13.2 percent of the stock of Dodge Manufacturing Company in a takeover attempt. Dodge defensively merged with Reliance, leaving Emerson in a position analogous to that of Occidental in the Old Kern-Tenneco merger. Emerson thereupon sold enough shares of Dodge to bring its holdings down to 9.96 percent, and two weeks later (also within the statutory six month period) sold its remaining shares.[76]

The Court ruled that Emerson's liability under section 16(b) encompassed the first sale, but not the second. By selling enough shares to become owner of less than ten percent of the shares of Dodge, Emerson had ceased to be a "beneficial owner" under section 16(b). The two-step selldown procedure was upheld as technically legal, despite its being part of a single plan to dispose of the Dodge shares.[77]

---

[70] See Lowenfels, supra note 41, at 58.

[71] 342 F.2d at 307.

[72] 425 F.2d 348 (2d Cir. 1970). *Newmark* involved the merger of Central Airlines, Inc. into Frontier Airlines, Inc., the latter 56%-owned by RKO General. Considerable profits accrued to RKO, reflecting the difference between the purchase price of Central securities and their market value in the equivalent in Frontier shares on the date of the merger.

[73] Id. at 353.

[74] Comment, Stock Exchanges Pursuant to Corporate Consolidation: A Section 16(b) "Purchase or Sale"?, 117 U. Pa. L. Rev. 1034, 1039 & n.28 (1969).

[75] 404 U.S. 418 (1972).

[76] Id. at 420-21. The first sale left Emerson the owner of less than the ten percent holdings which constitute the statutory definition of a "beneficial owner."

[77] Id. at 425. The Eighth Circuit had compared the procedure to permissible tax

The Court, speaking through Mr. Justice Stewart, declared 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."[78] The statutory definition of "beneficial owner" gives no room for alternative construction; by disposing of a portion of its holding, Emerson had ceased to be a beneficial owner. Equally, the cash sale by Emerson left no question that this was an orthodox sale by a beneficial owner—completely within section 16(b). If the three-question subjective test is applied to the facts of the first sale in *Emerson,* the first answer is that there is an orthodox sale, and questions two and three concerning the possibility of speculative abuse and actual sale within six months are never reached. When the second sale is considered, it becomes clear that there is no section 16(b) problem or orthodox sale because Emerson had ceased to be a statutory insider. Questions two and three are inapplicable in both cases since the sales in *Emerson* were for cash and both questions are dependent upon a negative answer to the first question.

The critical difference between *Emerson* and *Occidental* is that the latter was an unorthodox transaction, which led the Court to examine the facts of the case rather than characterizing the events as a section 16(b) infraction as a matter of law. The former case involved an orthodox transaction, and the Supreme Court never reached the question of the possibility of speculative abuse. That question is reached under the subjective test if and only if there exists some question as to whether a "purchase and sale" or "sale and purchase" has taken place. The definition of beneficial ownership, and the requirement that a beneficial owner be such both at the time of purchase and of the sale, or vice versa, are *not* subject to any subjective inquiry. The *Emerson* court was thus unable to apply a subjective interpretation, despite favorable comments concerning that test: the facts in *Emerson*—an actual and immediate sale for cash—require a mechanistic application of section 16(b) under *any* test. On the other hand, if the three-question subjective test is applied to the *Occidental* facts, the first question of the existence of a cash sale is answered negatively; the second question regarding the possibility of speculative abuse is answered negatively; and the third question regarding a "purchase and sale" or "sale and purchase" is never reached.

The crucial issue presented in complex stock transactions where section 16(b) liability might accrue under the subjective test is the question of speculative abuse. In *Occidental,* Tenneco attempted unsuccessfully to rely upon a superficially similar case, *Bershad v.*

avoidance schemes. Emerson Elec. Co. v. Reliance Elec. Co., 434 F.2d 918, 925 (8th Cir. 1970).

[78] 404 U.S. at 424.

McDonough,[79] in which the Seventh Circuit applied the subjective test to an option contract fact situation and found section 16(b) liability present. Under the facts in that case, McDonough and his wife had purchased in March 1967 more than ten percent of the outstanding shares of Cudahy Company. Soon thereafter he became a director and chairman of the board. In July 1967 they sold an "option" on their shares; the option was exercised a week after the statutory six month period expired. The defendants argued that the July sale was simply an option. However, McDonough had resigned from the board in July and was replaced by his "optionee;" he granted an irrevocable proxy to the optionee; and the option price of fourteen percent of total purchase price was not returnable. On the basis of these facts, the Seventh Circuit declared that "[t]he circumstances of the transaction clearly indicate that the stock was effectively transferred, for all practical purposes, long before the exercise of the option."[80] By granting voting control subsequent to the option, sufficient control had passed from the eventual seller's hands to suggest an actual sale.[81] *Occidental* presents no such maneuvers. The option was genuine and granted no control to Tenneco; at the same time, the merger presented no possibility of inside knowledge and therefore no possibility of speculative abuse by Occidental. An application of the subjective approach's threshold question of the possibility for speculation thus relieved Occidental of any liability under section 16(b).

The importance of the reasoning used in *Occidental* cannot be overestimated. Although the holding itself is tied to a narrow fact pattern, the test used to reach that holding is applicable to all future 16(b) litigation involving unorthodox transactions. By adopting the subjective test, the Court has resolved the confusion in the lower courts over interpretation of section 16(b) by endorsing the approach taken "[b]y . . . the greater weight of authority."[82] It must be remembered that Occidental's avoidance of section 16(b) liability was possible only because this was an *unorthodox* purchase and sale situation: the Court specifically states by way of dicta that a cash sale by Occidental "would have been a § 16(b) sale and would have left Occidental with a prima facie § 16(b) liability."[83] The involuntary nature of events with respect to Occidental's position in Old Kern stock once Tenneco had decided to merge with Old Kern is also prominent in the Supreme Court's opinion.[84] It should be noted that Occidental was attacked not only on the basis of its grant of an option to take effect in six months but also on the ground that the irrevocable rights to Tenneco preference stock which accrued on

[79] 428 F.2d 693 (7th Cir. 1970).

[80] Id. at 698.

[81] Id.

[82] 411 U.S. at 594 n.26.

[83] Id. at 600.

[84] Id.

August 30, standing alone, constituted a section 16(b) violation. The Court concluded that in light of Occidental's powerless position with respect to the merger, no section 16(b) liability should accrue merely from the closing of the merger.[85]

The specificity of the Court's assertion that a cash sale would have left Occidental with a prima facie section 16(b) liability suggests that the *Occidental* decision must not in any way be viewed as overruling *Emerson,* which provides the standards governing those situations in which it is obvious that a "purchase" or "sale" has taken place. In all but the most clear-cut cases of purchase and sale, the courts must undertake an in-depth analysis of the facts of each transaction. This analytical requirement has a clear disadvantage. In dissent, Mr. Justice Douglas complains that the substitution of the requirement of in-depth analysis of the possibility of abuse for the objective test's mechanical formula will result in numerous problems:

> Instead of a section that is easy to administer and by its clear-cut terms discourages litigation, we have instead a section that fosters litigation because the Court's decision holds out the hope for the insider that he may avoid § 16(b) liability. In short, the majority destroys much of the section's prophylactic effect.[86]

The complaint has some validity. There is little doubt that opening such questions as the possibility of "speculative abuse" to judicial inquiry will lead to rulings on the basis of very narrow questions of fact. On the other hand, the courts' inquiry into the facts of a case is limited under the *Occidental* ruling solely to the question of whether speculative abuse was possible. Refusal to inquire would mean, on the facts in *Occidental,* that the target of a tender offer could not only solicit a better offer, but could hold out to the new offeror the bait of section 16(b) liability on the part of the original offeror, if the transaction could be squeezed through in six months.[87] This sort of rule would discourage tender offers for more than ten percent of the target's outstanding shares; since corporate takeover is difficult under such conditions, far fewer takeovers would succeed. The policy considerations of that result are beyond the scope of this note, but since the intent of section 16(b) is to benefit the stockholders of corporations, it is sufficient to note that Old Kern's stockholders benefited considerably as a result of Occidental's takeover attempt.

Adherence to an objective standard would be contrary to the stated intent of the legislation. The sacrifice of judicial simplicity which the three-step subjective approach requires is merely inciden-

---

[85] Id.
[86] Id. at 612 (dissenting opinion).
[87] See *Abrams,* 450 F.2d at 163-64.

tal to the benefits the three-question test conveys. If criticism is to be leveled at the Court for its decision in *Occidental,* it should be leveled not because of the decision itself, but for the long delay in reaching it.

It is submitted that the *Occidental* decision, when read with *Emerson,* provides a conclusive answer to the theoretical questions arising under section 16(b). It may be expected that considerable litigation will result from the decision, since the "possibility of speculative abuse" standard is sufficiently vague to allow different conclusions to be drawn from the same set of facts. In the future, avoidance of at least a portion of section 16(b) liability will be relatively easy for the instigator of an unsuccessful attempt at corporate takeover: he may either sell down in two steps, as in *Emerson,* or else negotiate a "call" option with the survivor of the defensive merger negotiated to block his takeover, as in *Occidental.* The choice of which of these alternatives to adopt will depend upon the defeated tender offeror's assessment of likely future market prices and his willingness to gamble on the all-or-nothing question of the possibility of speculative abuse. Since the costs of protracted securities litigation are enormous, and since extended litigation is more likely in situations similar to *Occidental* than in those similar to *Emerson,* it is to be expected that many future defeated tender offerors will elect the two-step selldown procedure of *Emerson.* For defeated tender offerors, *Occidental* provides a high-risk alternative when caught in an untenable position. From the perspective of enforcement of section 16(b), *Occidental* provides an affirmation that the intent of the legislation is far more important than is the application of the mechanical test established to carry out that intent.

JOHN K. OLSON

Federal Communications Commission—Review of Regulations Relating to Provision of Data Processing Services by Communications Common Carriers—*GTE Service Corp. v. FCC.*[1]—In 1966 the Federal Communications Commission (FCC or Commission) by formal announcement in a Notice of Inquiry[2] opened an investigation into a broad and increasingly significant area of rapid technological change in our society: the convergence of the data processing and communications industries due to increasing needs to transmit computer-stored data between data processing users in different places. The Commission was concerned lest the rapid technological changes in the communications and data processing

---

[1] 474 F.2d 724 (2d Cir. 1973).

[2] In re Regulatory and Policy Problems Presented by the Interdependence of Computer and Communication Services and Facilities, 7 F.C.C.2d 11 (1966).