

CASE NOTES

Securities Law—Ten Percent Stock Ownership—Prerequisite to Section 16(b) Short-Swing Liability—*Provident Securities Co. v. Foremost-McKesson, Inc.*¹—In late 1968 Provident Securities Company decided to liquidate its assets. Provident hoped to sell its assets for cash since this would facilitate distribution of the proceeds of the liquidation to its shareholders. Foremost-McKesson, Inc. expressed an interest in purchasing Provident but desired to exchange its own securities for the Provident assets. The parties eventually reached a compromise whereby Provident agreed to accept Foremost convertible debentures in exchange for two-thirds of Provident's assets. Foremost agreed to register one-half of these debentures under the relevant provisions of the Securities Act of 1933² promptly after closing in order to permit them to be offered to the public.³ Since the debentures were immediately convertible into Foremost common stock in excess of ten percent of Foremost outstanding shares,⁴ Provident became a beneficial owner of ten percent of a class of equity securities as provided in section 16(a) of the Securities Exchange Act of 1934.⁵ An underwriting agreement was executed on October 21, 1969. Under that agreement, Provident sold one of the debentures. On October 24, additional debentures were distributed by Provident to its shareholders and Provident ceased to be a ten percent owner of Foremost securities. The underwriting agreement was closed on October 28 and the cash was distributed to Provident shareholders on the following day.⁶

Subsequently, Provident brought an action for a declaratory judgment to determine its non-liability to Foremost for short-swing profits under section 16(b) of the Securities Exchange Act of 1934.⁷

¹ 506 F.2d 601 (9th Cir. 1974), cert. granted, 420 U.S. 923 (1975).

² 15 U.S.C. §§ 77e-g (1970).

³ 506 F.2d at 603.

⁴ Id.

⁵ 15 U.S.C. § 78p(a) (1970).

⁶ 506 F.2d at 604.

⁷ 15 U.S.C. § 78p(b) (1970) 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 at law or in equity in any court of competent jurisdiction by the issuer, or by the owner of any security of the issuer in the name and in behalf of the issuer if the issuer shall fail or refuse to bring such suit within sixty days after request or shall fail diligently to prosecute the same thereafter; but no such suit shall be brought more than two years after the date such profit was realized. This subsection shall not be construed to cover any transaction where such

Foremost counterclaimed for a declaration of liability and recovery of profits.⁸ On cross motions for summary judgment, the United States District Court for the Northern District of California held that Provident was not liable for short-swing profits under section 16(b) since its sale of assets contained no potential for speculative abuse of inside information.⁹ Additionally, the district court reasoned that a recovery by Foremost would result in a windfall and perpetrate an inequity upon Provident.¹⁰

On appeal, the United States Court of Appeals for the Ninth Circuit affirmed the district court¹¹ on the narrow basis of its interpretation of the section 16(b) ownership proviso.¹² The court of appeals HELD: the initial purchase by which a person increases his holdings to over ten percent of a corporation's securities is not a section 16(b) transaction and thus there is no statutory strict liability for profits from the sale of such holdings within six months from the date of purchase.¹³ Since the acquisition by Provident was the initial purchase which made it a ten percent owner of Foremost securities, the court refused to impose liability for profits from the subsequent sale of those securities.¹⁴

The significance of *Provident Securities* lies in the Ninth Circuit's interpretation of the section 16(b) requirement that a beneficial owner must be such "both at the time of purchase and sale" in order for short-swing liability to attach.¹⁵ The court construed this language to mean that, in order for a beneficial owner to be liable for profits obtained from a purchase and sale of corporate securities completed within six months, such beneficial owner must be a ten percent owner of the corporation's securities *prior to* the purchase in question.¹⁶ All of the circuits which have previously decided this issue have construed the section 16(b) language to mean that one becomes a ten percent owner *simultaneously with* the initial purchase by which he increases his securities holdings to ten percent, and therefore that liability will attach for profits obtained on any

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.

⁸ *Provident Sec. Co. v. Foremost-McKesson, Inc.*, 331 F. Supp. 787 (N.D. Cal. 1971).

⁹ *Id.* at 791-92.

¹⁰ *Id.* at 792.

¹¹ 506 F.2d at 614.

¹² 15 U.S.C. § 78p(b) (1970), the ownership proviso of which states:

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.

¹³ 506 F.2d at 614.

¹⁴ *Id.* at 615.

¹⁵ 15 U.S.C. § 78p(b) (1970).

¹⁶ 506 F.2d at 614.

sale within six months.¹⁷ While the decision in *Provident Securities*, by limiting the category of transactions to which short-swing liability may attach, mitigates some of the harshness of section 16(b), some may argue that the result creates a loophole which could reduce its effectiveness.¹⁸

Initially, this note will briefly present the policy considerations underlying section 16(b). The rationale of *Provident Securities* will then be analyzed and compared with prior decisions advocating the alternative interpretation of the section 16(b) ownership proviso. These two approaches will be compared and discussed in light of the limited policies of section 16(b) and with regard to a logical statutory construction of the plain language of section 16(b). Finally, to provide a sound basis for suggesting the proper interpretation of the section 16(b) ownership proviso, the analysis will focus upon dicta in recent Supreme Court decisions.

Section 16(b) of the Securities Exchange Act of 1934¹⁹ was enacted to deter corporate insiders from engaging in short-swing transactions in the securities of their own corporations.²⁰ This section was designed to maintain investor confidence in a free and open securities market by ensuring that individuals with access to inside information do not abuse their fiduciary position.²¹ In order to achieve these objectives, section 16(b) provides for strict liability for profits derived from transactions violating the statute.²² Thus, any corporate insider²³ engaging in a purchase and sale, or sale and purchase, of his corporation's securities within a six month period will be liable to the issuer for any profits resulting from the transac-

¹⁷ See *Emerson Elec. Co. v. Reliance Elec. Co.*, 434 F.2d 918 (8th Cir. 1970), aff'd on other grounds, 404 U.S. 418 (1972); *Newmark v. RKO Gen., Inc.*, 425 F.2d 348 (2d Cir.), cert. denied, 400 U.S. 854 (1970); *Stella v. Graham-Paige Motors Corp.*, 232 F.2d 299 (2d Cir.), cert. denied, 352 U.S. 831 (1956).

¹⁸ See Seligman, *Problems Under the Securities Exchange Act*, 21 Va. L. Rev. 1, 20 (1934).

¹⁹ 15 U.S.C. § 78p(b) (1970). For the text of § 16(b), see note 7 supra.

²⁰ Senate Comm. on Banking and Currency, S. Rep. No. 792, 73d Cong., 2d Sess. 9 (1934).

The bill further aims to protect the interests of the public by preventing directors, officers, and principal stockholders of a corporation . . . from speculating in the stock on the basis of inside information not available to others. . . . Such a provision will render difficult or impossible the kind of transactions which were frequently described to the committee, where directors and large stockholders participated in pools trading in the stock of their own companies, with benefit of advance information regarding an increase or resumption of dividends in some cases, and the passing of dividends in others.

Id. For a discussion of some market practices which were common before the enactment of § 16(b), see Comment, *The Scope of "Purchase and Sale" Under Section 16(b) of the Exchange Act*, 59 Yale L.J. 510 (1950).

²¹ See *Adler v. Klawans*, 267 F.2d 840, 844 (2d. Cir. 1959).

²² *Feder v. Martin Marietta Corp.*, 406 F.2d 260, 262 (2d Cir. 1969), cert. denied, 396 U.S. 1036 (1970).

²³ For purposes of this discussion, "insider" includes directors, officers, and beneficial owners of more than 10% of any class of equity security. See 15 U.S.C. § 78p(a) (1970).

tion. Such liability is not dependent upon proof of the insider's intent or proof of the actual use of inside information.²⁴

Although section 16(b), by providing for strict liability, has been condemned as unduly harsh,²⁵ the actual scope of its coverage is narrow. Only those persons defined as corporate insiders by section 16(a) can incur liability under section 16(b).²⁶ The drafters concluded that these individuals not only had the greatest access to inside information but also were in a position to manipulate corporate affairs to enhance their own trading positions.²⁷ Additionally, the statute reaches only those situations where an insider is involved in two transactions within a six month period.²⁸ This time limitation is a recognition that the passage of six months is likely to neutralize any advantage of the insider over the investing public that otherwise would result from the insider's access to inside information. The influence of impending events or corporate action upon market prices would probably dissipate during this period. In addition, such information may become public during the interim. Thus, holding the securities for six months leads to an inference of bona fide long-term investment.²⁹

While section 16(b) was written as a clear and easily applicable provision, the courts have been presented with the problem of construing the ambiguous section 16(b) ownership proviso, which states that the section shall not cover any transaction where a beneficial owner³⁰ of ten percent of a class of equity securities was not such "both at the time of purchase and sale"³¹ The specific question presented by this language is whether the transaction by which an individual acquires ten percent of a corporation's securities should be construed as a purchase within the meaning of section 16(b) so that the individual will be liable for profits obtained from a sale of those securities within six months. The court in *Provident Securities* answered this question by holding that Provident was not liable for the profits it had obtained from the sale of Foremost debentures.³² The court interpreted the statutory language as mean-

²⁴ See *Smolowe v. Delendo Corp.*, 136 F.2d 231, 235-36 (2d Cir.), cert. denied, 320 U.S. 751 (1943).

²⁵ Lowenfels, Regulation 16(b): A New Trend in Regulating Insider Trading, 54 Cornell L. Rev. 45, 64 (1968).

²⁶ *Blau v. Lehman*, 368 U.S. 403, 409 (1962). See note 23 supra.

²⁷ Hearings on S. 84, S. 56 and S. 97 Before the Senate Comm. on Banking and Currency, 73d Cong., 1st Sess., pt. 15, at 6463-581 (1934).

²⁸ *Adler v. Klawans*, 267 F.2d 840, 845 (2d Cir. 1959).

²⁹ See Comment, The Scope of "Purchase and Sale" Under Section 16(b) of the Exchange Act, 59 Yale L.J. 510, 511 (1950).

³⁰ The Securities Exchange Act contains no definition for beneficial owner. It has been stated that a person is a beneficial owner when he has "a substantial property interest therein, sufficient for the purposes of entering into [a] contract of sale; no particular form of legal or equitable title is required to satisfy the requirements" *Fuller v. Dilbert*, 244 F. Supp. 196, 215 (S.D.N.Y. 1965), aff'd mem., 358 F.2d 305 (2d Cir. 1966). See also L. Loss, Securities Regulation 1100-08 (2d ed. 1961).

³¹ 15 U.S.C. § 78p(b) (1970). For the text of § 16(b), see note 7 supra.

³² 506 F.2d at 614.

ing that the transaction by which one becomes a ten percent owner cannot be used in determining liability under section 16(b).³³

The Ninth Circuit justified its interpretation by noting initially that section 16(b) creates a conclusive presumption that a statutory insider who sells and purchases or purchases and sells within six months does so with the intent to speculate rather than to invest.³⁴ Since this presumption is conclusive, the court believed that Congress intended that the class of insiders be narrowly confined to those who could have access to inside information. This class does not include outsiders.³⁵ Since one who increases his holdings to ten percent of a corporation's shares is an outsider at the time he makes the decision, for purposes of the statutory presumption, any inside information in his possession could not have been obtained "by reason of his relationship to the issuer."³⁶ Therefore, the Ninth Circuit concluded that this initial purchase is not within the intended scope of section 16(b).³⁷

The court in *Provident Securities* was careful to limit its construction to initial purchases which bring a shareholder over ten percent ownership.³⁸ Thus, it would not be possible for a ten percent shareholder to sell below ten percent, repurchase at a profit and claim immunity on the ground that at the time of repurchase, he held less than ten percent of the outstanding shares. At the time of repurchase the requisite inside relationship to the issuer would exist by virtue of the shareholder's prior holdings. Therefore, in this case such an individual would be held to become again a ten percent owner *simultaneously with* the repurchase of securities. The Ninth Circuit reasoned that while such an interpretation would result in two different applications of the same term, this result would be in keeping with the basic rationale of section 16(b).³⁹ On the basis of this reasoning, the court concluded that the exchange of Provident's assets for Foremost debentures was the initial transaction in which Provident acquired ten percent ownership of Foremost securities. Since Provident had not been a ten percent owner prior to this acquisition, it could not be liable for profits obtained from a subsequent sale within six months.⁴⁰

In reaching its decision, the court in *Provident Securities* had guidance only from the small amount of case law concerning the ownership proviso of section 16(b). The first treatment of the issue was the decision by Judge Kaufman on motion for summary judgment in *Stella v. Graham-Paige Motors Corp.*⁴¹ There, a sharehol-

³³ Id.

³⁴ Id. at 611.

³⁵ Id. at 614.

³⁶ 15 U.S.C. § 78p(b) (1970).

³⁷ 506 F.2d at 611-14.

³⁸ Id. at 614.

³⁹ Id.

⁴⁰ Id. at 615.

⁴¹ 104 F. Supp. 957 (S.D.N.Y. 1952). Final disposition of the trial is reported at 132 F.

der, in one purchase, increased his holdings of a corporation's stock from 9.25 percent to 21 percent. Within six months of this purchase, he sold some of his shares.⁴² The federal district court interpreted the language of the ownership proviso to mean that an individual becomes a ten percent owner, within the terms of section 16(b), *simultaneously with* the initial purchase which brings his holdings above ten percent and therefore, that such a purchaser will be liable for profits obtained from a subsequent sale within six months.⁴³ This interpretation was accepted by the Court of Appeals for the Second Circuit without comment.⁴⁴

In *Stella*, Judge Kaufman had concluded that the *simultaneously with* construction was the only one which could appropriately effectuate the congressional purpose of deterring insider abuse.⁴⁵ He expressed the fear that if the statute was construed to impose liability only where the defendant held ten percent or more of the securities prior to the initial purchase, a loophole would result which would defeat the legislative intent.⁴⁶ Instead, Judge Kaufman believed that the ownership proviso was intended merely to exclude the second sale in a two step sell down situation as a basis for section 16(b) liability.⁴⁷ This application of the ownership proviso would involve a ten percent owner engaging in two sales within six months of the purchase. If the first sale reduced his holdings to below ten percent, only profits obtained from the first sale would be recoverable, since at the time of the second sale such individual would no longer be a ten percent owner.⁴⁸

Judge Kaufman's simultaneous ownership interpretation of the section 16(b) ownership proviso was reaffirmed in 1970 by the Second Circuit, on slightly different grounds, in *Newmark v. RKO General, Inc.*,⁴⁹ which involved a contract for the sale of stock to RKO General in connection with the merger of Frontier Airlines and Central Airlines.⁵⁰ RKO General owned 56 percent of Frontier's shares and contracted with several Central shareholders to acquire their shares. This transaction made RKO General a ten percent owner of Central securities. Within six months of this purchase, RKO General exchanged its Central shares for Frontier shares according to the merger agreement.⁵¹ The court followed the *Stella*

Supp. 100 (S.D.N.Y. 1955), modified, 232 F.2d 299 (2d Cir.), cert. denied, 352 U.S. 831 (1956).

⁴² 104 F. Supp. at 958.

⁴³ Id. at 960.

⁴⁴ 232 F.2d at 300-01.

⁴⁵ 104 F. Supp. at 959.

⁴⁶ Id. Judge Kaufman hypothesized that under the "prior to" construction, an individual would be able to buy over ten percent and then sell under ten percent, thereby reaping the profits and repeating the process ad infinitum. But see 506 F.2d at 614-15.

⁴⁷ 104 F. Supp. at 960.

⁴⁸ Id.

⁴⁹ 425 F.2d 348 (2d Cir.), cert. denied, 400 U.S. 854 (1970).

⁵⁰ 425 F.2d at 351.

⁵¹ Id. at 352.

decision in determining that the initial transaction which made RKO General a ten percent owner of Central securities was embraced by section 16(b).⁵² The court reasoned that the reference to ten percent owners in the statute rested on the presumption that these individuals have access to inside information. The court recognized that while this presumption of access to inside information could not be applied to the purchase in question, this purchase did place the individual in a position of access to inside information allowing a subsequent sale based on newly acquired knowledge. Therefore the initial purchase "creates an opportunity for the kind of speculative abuse the statute was enacted to prevent."⁵³ It would appear, however, that this reasoning fails to account for the fact that the language of section 16(b) applies a conclusive presumption of use of inside information only to a *pair* of transactions completed within six months. The court in *Newmark* recognized that such a presumption could be applied rationally to only one transaction in this situation and yet extended section 16(b) coverage to the initial purchase,⁵⁴ thus apparently extending the statute beyond the reach of its express language.

The only other circuit to deal with the issue was the Eighth Circuit, which also adopted the simultaneous ownership rule in *Emerson Electric Co. v. Reliance Electric Co.*⁵⁵ In *Emerson*, a corporation which had acquired 13.2 percent of the outstanding common stock of another corporation pursuant to a tender offer sold its holdings to below ten percent when its plan of a successful takeover failed.⁵⁶ The court held section 16(b) applicable in this situation since it believed that such an interpretation was necessary to give full effect to the congressional purpose of deterring insider abuse of inside information.⁵⁷

By examining the positions advocating the simultaneous ownership interpretation, it can be seen that there does exist a logical,

⁵² Id. at 356.

⁵³ Id. This reasoning is similar to that in 16(b) cases where the transactions involved are termed "unorthodox." In those cases, the court will examine the transaction to discover whether any potential for the abuse of inside information at which § 16(b) was aimed actually existed. The court will "apply the statute only when its application would serve its goals." *Kern County Land Co. v. Occidental Petroleum Corp.*, 411 U.S. 582, 595 (1973). See also *Petteys v. Butler*, 367 F.2d 528 (8th Cir. 1966), cert. denied sub nom. *Blau v. Petteys*, 385 U.S. 1006 (1967); *Blau v. Max Factor & Co.*, 342 F.2d 304 (9th Cir.), cert. denied, 382 U.S. 892 (1965); *Ferraiolo v. Newman*, 259 F.2d 342 (6th Cir. 1958).

For a discussion of "unorthodox" transactions see 2 L. Loss, *Securities Regulation* 1066-75 (2d ed. 1961). The court in *Provident Securities* had to deal with the subject of unorthodox transactions. However, the court concluded that the exchange of assets for securities was sufficiently orthodox so that a showing of potential for abuse was unnecessary to decide whether § 16(b) had been violated. 506 F.2d at 605.

⁵⁴ 425 F.2d at 356.

⁵⁵ 434 F.2d 918 (8th Cir. 1970), aff'd on other grounds, 404 U.S. 418 (1972).

⁵⁶ 434 F.2d at 920.

⁵⁷ Id. at 924. See Seligman, *Problems Under the Securities Exchange Act*, 21 Va. L. Rev. 1 (1934).

though perhaps unpersuasive, rationale for adoption of that interpretation: while it is true that the terms of section 16(b) are narrow, the primary objective of the statute is broad; that is, to maintain investor confidence in the stock market by discouraging short-swing insider trading.⁵⁸ Since section 16(b) can be avoided easily it is necessary for the courts to interpret its terms liberally to effectuate the congressional intent fully. In addition, proponents of the *simultaneous with* interpretation of the ownership proviso could argue that the bite of section 16(b) is not harsh. The statute is basically remedial, not penal.⁵⁹ If a defendant is found liable there is no penalty, fine or even damages. The statute requires only a disgorging of profits which places the defendant in the same position he held before the forbidden transactions.⁶⁰ There is even a generous loophole provided for insiders by use of the two step sell down procedure in certain situations.⁶¹ Utilizing this scheme, a clever insider can still obtain substantial profits on the short swing. In view of these factors, it has been argued that courts should be reluctant to limit further the application of the statute lest it no longer function as a deterrent to insider abuse.⁶²

Until *Provident Securities*, no circuit had adopted the *prior to* interpretation. The rationale behind this interpretation was first articulated by Judge Hincks, dissenting in *Stella v. Graham-Paige Motors, Inc.*⁶³ Judge Hincks believed that the court had an obligation to interpret the words of the statute in their ordinary sense and to give effect to the plain language used by Congress.⁶⁴ He found no ambiguity in the statute.⁶⁵ The simultaneous ownership rule of the majority was seen as inconsistent with the expressed congressional intent. The statute, Judge Hincks argued, was based upon fiduciary obligations owed to the corporation by controlling shareholders. Under his analysis, Congress contemplated the imposition of the statutory conclusive presumption of a breach of that duty *only* when an individual completed both transactions within six months as an

⁵⁸ *Smolowe v. Delendo Corp.*, 136 F.2d 231, 235 (2d Cir.), cert. denied, 320 U.S. 751 (1943).

⁵⁹ *Adler v. Klawans*, 267 F.2d 840, 844 (2d Cir. 1959).

⁶⁰ However, there are cases where an insider will lose more than his profit. Where the insider has engaged in multiple purchases and sales within a six month period, the court will match the highest sale price with the lowest purchase price, even if the two transactions are not directly related. *Gratz v. Claughton*, 187 F.2d 46, 50 (2d Cir.), cert. denied, 341 U.S. 920 (1951); *Smolowe v. Delendo Corp.*, 136 F.2d 231, 237 (2d Cir.), cert. denied, 320 U.S. 751 (1943). Therefore an individual could sustain a net loss on the series of transactions and yet be liable for additional funds under this method of profit computation.

⁶¹ See text at note 48 *supra*. This procedure was ratified by the Supreme Court in *Reliance Elec. Co. v. Emerson Elec. Co.*, 404 U.S. 418 (1972).

⁶² *Emerson Elec. Co. v. Reliance Elec. Co.*, 434 F.2d 918, 924 (8th Cir. 1970), *aff'd* on other grounds, 404 U.S. 418 (1972).

⁶³ 232 F.2d 299, 302-05 (2d Cir.) (Hincks, J., dissenting), cert. denied, 352 U.S. 831 (1956).

⁶⁴ 232 F.2d at 303 (Hincks, J., dissenting).

⁶⁵ *Id.* at 304 (Hincks, J., dissenting).

insider.⁶⁶ Since the proviso was consciously left as a loophole by Congress after weighing the conflicting policies of overbreadth and insider abuse, he believed that the court should merely give effect to the plain language of section 16(b).⁶⁷ In *Arkansas Louisiana Gas Co. v. W.R. Stephens Investment Co.*,⁶⁸ the United States District Court for the Western District of Arkansas adopted the position advocated by Judge Hinck's dissent without comment.⁶⁹ Thus, the court refused to include the initial purchase which made the defendant a ten percent owner in computing recoverable profits after section 16(b) liability was established.⁷⁰

The court in *Provident Securities* chose the position which it regarded as the most consistent with the plain statutory language. This interpretation appears to give full effect to the plain language of Congress, and also seems to comport more fully with the limited policy and scope intended by section 16(b).

First, it cannot be contended that Congress intended the ownership proviso to remain superfluous. However, the decisions involving corporate directors and officers illustrate that this is the result when the simultaneous ownership rule is adopted. Section 16(b) treats these insiders in a manner different from ten percent owners of securities. There is no proviso in the section requiring directors or officers to be such both at the time of purchase and sale.⁷¹ The reason for this difference is that officers and directors are in a better position than are ten percent owners to acquire inside information and to manipulate directly corporate affairs to their own trading advantage.⁷² Therefore, an individual who becomes a director has been held liable under section 16(b) for a purchase and sale of securities within six months, although that individual did not become a director until after the purchase.⁷³ An adoption of the simultaneous ownership rule would, in effect, treat ten percent owners and other insiders alike, despite the distinctive treatment in the section 16(b) ownership proviso. It cannot be maintained that the proviso has no effect at all.

In *Stella*, Judge Kaufman rebutted this argument by adopting the two step sell down interpretation. He contended that the proviso was meant only to exclude the profits obtained from a second sale within six months of a purchase of securities, providing that the first sale reduced the shareholder's interest to below ten percent.⁷⁴ This

⁶⁶ Id. at 305 (Hincks, J., dissenting).

⁶⁷ Id.

⁶⁸ 141 F. Supp. 841 (W.D. Ark. 1956).

⁶⁹ Id. at 847.

⁷⁰ Id.

⁷¹ See *Adler v. Klawans*, 267 F.2d 840, 845 (2d Cir. 1959).

⁷² *Adler v. Klawans*, 267 F.2d 840, 845 (2d Cir. 1959).

⁷³ Id. at 840. See also *Feder v. Martin Marietta Corp.*, 406 F.2d 260 (2d Cir. 1969), cert. denied, 396 U.S. 1036 (1970) (where defendant who purchased stock while a director but sold after he left the board was held to be within § 16(b)).

⁷⁴ 104 F. Supp. at 960.

is the result because at the time of the second sale the shareholder would no longer be a ten percent owner. It is true that the proviso will support such a result on these facts. However, it does not appear that the plain language of the statute requires an interpretation that the applicability of the proviso is confined to this specific factual pattern. If this application of the ownership proviso were the only one possible, it would have the effect of always including within the terms of section 16(b) a purchase which cannot be presumed to be based on inside information acquired through substantial holdings, and yet exclude a second sale which, if the first sale is presumed to be based on inside information, cannot rationally be excluded from the scope of the presumption. Moreover, had Congress intended such a narrow result it could have made that intent more clear than appears from the broad language of the proviso.

Additionally, the *prior to* construction may comport more fully with the limited policy and scope of section 16(b). Although the legislative history on this point fails to illuminate the controversy, the courts agree that where two conflicting interpretations of the section are possible, that interpretation which best effectuates legislative purpose must be applied.⁷⁵ Part of that legislative purpose was to deter insiders from taking advantage of their position of access to information not available to the public.⁷⁶ However, Congress did not intend section 16(b) to cover all cases of abuse of inside information. Rather, the section was designed to prevent the most odious kind of abuse—the violation by powerful corporate insiders of their fiduciary duties in managing corporate affairs.⁷⁷ Accordingly, the statute was drafted narrowly to apply to the limited class of individuals who were believed not only to have access to inside information but also to be in a position of control from which corporate affairs could be manipulated to an extent which would make short-swing profits more easily attainable.⁷⁸

In addition, there is other evidence that Congress intended that a narrow scope be given to the category of transactions for which strict liability is imposed. Section 16(b) is aimed only at situations where an insider engages in a purchase *and* sale within six months. Therefore, an insider may engage in *either* a sale *or* a purchase of securities with impunity under section 16(b), even where inside information is used.⁷⁹ Similarly, an insider may purchase securities,

⁷⁵ *Reliance Elec. Co. v. Emerson Elec. Co.*, 404 U.S. 418, 424 (1972); accord, *Adler v. Klawans*, 267 F.2d 840, 844 (2d Cir. 1959).

⁷⁶ Section 16(b) was designed: "To protect the interests of the public against the predatory operations of directors, officers, and principal stockholders of corporations by preventing them from speculating in the stock of corporations to which they owe a fiduciary duty." S. Rep. No. 1455, 73d Cong., 2d Sess. 68 (1934).

⁷⁷ *Id.*

⁷⁸ "Senator Gore. This [section 16(b)] is aimed at the general evil of officers and directors rigging their stock up and down, and squeezing out their own stockholders. *Corcoran*. Yes." Hearings on S. 84, S. 56 and S. 97 Before the Senate Comm. on Banking and Currency, 73d Cong., 1st Sess., pt. 15, at 6559 (1934).

⁷⁹ *Blau v. Max Factor & Co.*, 342 F.2d 304, 307 (9th Cir.), cert. denied, 382 U.S. 892

wait six months and one day to sell, and not be accountable for any profit.⁸⁰ Apparently, Congress desired to keep the section's coverage narrow so as not to discourage bona fide long term investment.⁸¹

The operation of the simultaneous ownership interpretation may be inconsistent with this narrow coverage accorded section 16(b). An individual who acquires an initial ten percent interest in a corporation in one purchase and then sells within six months, is engaging in only one transaction while an insider. In such a case liability has been justified on the ground that once the individual obtains over ten percent of a corporation's securities, he has access to inside information which can be used to his advantage in selling within six months.⁸² This is not a strong justification, however, since a director, officer, or long term ten percent owner can also engage in only one transaction on the basis of inside information within a six month period and yet be immune from section 16(b)'s strict liability provisions. The section only imposes its conclusive presumption that transactions were based on inside information where there is a coupling of a purchase and a sale within six months. The ten percent owner who sells securities within six months of the initial purchase which gave him that interest is in no better position to capitalize on inside information than is another insider who engages in only one transaction in six months, and yet to whom no section 16(b) liability will attach. In fact, the potential abuses at which section 16(b) was aimed are more likely to occur in the latter situations since those insiders have far more time and opportunity to become acquainted with corporate affairs and to engage in manipulative practices. Assigning liability in one situation and not in the other would appear paradoxical and inequitable.

The fear of those opposing the *prior to* construction is that such construction would enable an individual to purchase a large block of a corporation's securities, sell the securities until his ownership was just below ten percent and then repeat the process, ad infinitum, without liability.⁸³ The court in *Provident Securities*, attempted to solve this problem by adopting the *prior to* construction only in the case of an initial purchase of ten percent interest. In dictum, the Ninth Circuit stated that in all other situations, it would treat the individual as a ten percent owner simultaneously with the repurchase of over ten percent of a class of equity securities.⁸⁴ Such an interpretation would apply two separate meanings to the same

(1965). However, liability could attach to such a transaction under Rule 10b-5, 17 C.F.R. § 240.10b-5 (1974), if actual use of inside information were proven. See, e.g., *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 848 (2d Cir. 1968), cert. denied, 394 U.S. 976 (1969).

⁸⁰ *B.T. Babbett, Inc. v. Lachner*, 332 F.2d 255 (2d Cir. 1964).

⁸¹ *Bershad v. McDonough*, 428 F.2d 693, 696 (7th Cir. 1970), cert. denied, 400 U.S. 992 (1971).

⁸² *Newmark v. RKO Gen., Inc.*, 425 F.2d 348, 356 (2d Cir. 1970).

⁸³ *Stella*, 104 F. Supp. at 959.

⁸⁴ 506 F.2d at 614.

statutory language. However, this approach would appear to be consistent with the policy of the statute.⁸⁵ Yet this interpretation involves some sticky problems of its own. For instance, it is unclear how long and under what circumstances the simultaneous ownership interpretation would apply to the repurchase of securities. It is conceivable that an individual would sell all of his holdings and then repurchase a ten percent interest five years later. Would he be held to have become a ten percent owner simultaneously with the repurchase because of a relationship he enjoyed with the issuer five years previously?

The real problem presented by the Ninth Circuit's dictum is one of line drawing. The court in *Provident Securities* did not raise this question, but it is implicit in the interpretation it gave to the proviso. The problem could possibly be treated by the courts by weighing the facts and circumstances of each case. However, the ultimate responsibility for resolving this ambiguity lies with Congress.⁸⁶

Although the Supreme Court has never ruled directly on the proper construction of the section 16(b) ownership proviso, dicta in some of its recent section 16(b) decisions seem to indicate a recognition of the limited policies and scope of the statute, and in that way support the Ninth Circuit's narrow interpretation of the scope of section 16(b) liability. In *Reliance Electric Co. v. Emerson Electric Co.*,⁸⁷ the Court, basing its decision upon the section 16(b) ownership proviso, ratified the use of a two step sell down scheme to avoid liability for the second sale.⁸⁸ However, the question of whether an individual's initial purchase of ten percent of a corporation's securities can be included under section 16(b) was not before the Court.⁸⁹ In rejecting the dissenters' argument that all sales by a ten percent owner within six months of a purchase are tainted because of the possibility of abuse of inside information,⁹⁰ the Court stated:

While there may be logic in this position, it was clearly rejected as a basis for liability when Congress included the proviso that a 10% owner must be such both at the time of the purchase and of the sale. Although the legislative history affords no explanation of the purpose of the proviso, it may be that Congress regarded one with a long-term investment of more than 10% as more likely to have access

⁸⁵ Some engaging in buying and selling above and below ten percent has enjoyed an access to inside information "by reason of his relationship to the issuer." 15 U.S.C. § 78p(b) (1970). Therefore, in these limited situations, the policy of § 16(b) would be served by the simultaneous ownership interpretation.

⁸⁶ See text at notes 100-02 *infra*.

⁸⁷ 404 U.S. 418 (1972). For a discussion of this case see Note, 14 B.C. Ind. & Com. L. Rev. 560 (1973). For the facts of this case see text at notes 55-57 *supra*.

⁸⁸ 404 U.S. at 420.

⁸⁹ *Id.* at 421.

⁹⁰ *Id.* at 442 (dissenting opinion).

to inside information than one who moves in and out of the 10% category. But whatever the rationale of the proviso, it cannot be disregarded simply on the ground that it may be inconsistent with our assessment of the "wholesome purpose" of the Act.⁹¹

Although this decision cannot be construed as an acceptance of the *prior to* construction by the Court, it may be viewed as an instance where the Court reaffirmed the narrow scope of section 16(b)'s strict liability terms.⁹² This language is a recognition by the Court that the explicit language of the ownership proviso cannot be disregarded because of unexpressed policy objectives.

More recent Supreme Court dicta would seem to indicate that the Court would be amenable to the *prior to* construction. *Kern County Land Co. v. Occidental Petroleum Corp.*⁹³ involved a tender offer campaign in which Occidental attempted a takeover of Kern. These takeover efforts failed when Kern effected a defensive merger with a third corporation. Occidental was then forced to exchange its shares in Kern for shares of the new corporation. Kern brought suit to recover Occidental's profits on the exchange.⁹⁴ The Court resolved the case by deciding that the transactions did not have a potential for the type of abuse at which section 16(b) was aimed.⁹⁵

The facts of *Kern* involved more than one tender offer, and after the initial offer was accepted Occidental became a ten percent owner. In briefly discussing this initial offer situation, the Court stated: "[t]here is no basis for a finding that, at the time the tender offer was commenced, Occidental enjoyed an insider's opportunity to acquire information about Old Kern's affairs."⁹⁶ Furthermore, even if Occidental had made its initial tender offer on the basis of some information not available to the public, this did not "represent the kind of speculative abuse at which [section 16(b)] is aimed, for it could not have been based on inside information obtained from substantial stockholdings that did not yet exist."⁹⁷ This dicta would seem to indicate that the Court views section 16(b) as encompassing only those transactions in which a person has access to inside information by reason of an insider relationship to the issuer both at the time of the purchase and sale. That relationship cannot exist *simultaneously with* the purchase which makes an individual a ten percent owner, and therefore, under this analysis, no liability should attach to the purchase under section 16(b).

⁹¹ Id. at 424 (emphasis added).

⁹² Id. at 422.

⁹³ 411 U.S. 582 (1973). For a discussion of this case see Note, 15 B.C. Ind. & Com. L. Rev. 149 (1973).

⁹⁴ 411 U.S. at 590.

⁹⁵ Id. at 600.

⁹⁶ Id. at 596-97.

⁹⁷ Id. at 597.

The court in *Provident Securities* based its conclusions, in part, upon this dicta by the Supreme Court.⁹⁸ Logically, it is a sound position, and it need not be feared that such an interpretation will place corporations and the public at the mercy of unscrupulous speculating insiders. Many transactions which may escape the limited purview of section 16(b)'s strict liability provisions can be remedied by civil suits based on Rule 10b-5.⁹⁹

In the final analysis, it must be recognized that the ultimate decision and responsibility for defining the full force and scope of section 16(b) belongs to Congress. If the statute is to be broadened to the extent that is envisioned by the simultaneous ownership rule, that broadening should be done by Congress. The American Law Institute has proposed a revised securities code which would incorporate the simultaneous ownership interpretation advanced by Judge Kaufman in *Stella*.¹⁰⁰ The drafters concede that a clarification is necessary because that broad construction of the present statutory language is questionable.¹⁰¹ However, these are policy judgments which properly belong in the legislative domain. The courts can only rationally interpret the plain language of the present statute.¹⁰²

The proper construction of the section 16(b) ownership proviso has been a source of disagreement among courts and commentators since the passage of the 1934 Act. A majority of courts, including all courts of appeals which have decided the issue, have opted for the simultaneous ownership interpretation. In *Provident Securities*, the Ninth Circuit has broken with that line of cases by holding that an individual is not liable under section 16(b) for profits resulting from a sale of securities which was completed within six months of the purchase, and by which the individual obtained an initial ten percent ownership interest in those securities.

It is submitted that the *Provident Securities* decision was correct in view of proper canons of statutory construction, the actual policy underlying section 16(b), and recent illuminating dicta from

⁹⁸ 506 F.2d at 609.

⁹⁹ See, e.g., *Mitchell v. Texas Gulf Sulphur Co.*, 446 F.2d 90 (10th Cir.), cert. denied, 404 U.S. 1004 (1971). Rule 10b-5, 17 C.F.R. § 240.10b-5 (1974), reads:

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,

(a) To employ any device, scheme, or artifice to defraud,

(b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

¹⁰⁰ ALI Federal Securities Code, Tentative Draft No. 2, Pt. XIV § 1413(d), at 129 (March 1973).

¹⁰¹ Id. § 1413, Comment (6)(a), at 134.

¹⁰² See *Reliance Elec. Co. v. Emerson Elec. Co.*, 404 U.S. 418, 427 (1972).

the Supreme Court. The conclusive presumption of use of inside information under section 16(b) should not be extended to cover an initial purchase of a ten percent interest, since at the time of that purchase, the individual did not enjoy the relationship with the issuer which, under the statute's terms, would facilitate access to such information. Finally, it is suggested that the courts should leave any expansion of section 16(b) coverage to Congress and that the role of the courts should be confined to effectuating the plain language of the statute in its present form.

JOSEPH PIZZURRO

Civil Procedure—Diversity Actions—Conflict Between Federal Rule and State Law with Direct Substantive Effect—*Marshall v. Mulrenin*.¹—Plaintiffs, Mr. and Mrs. Marshall, brought suit for personal injuries in the United States District Court for the District of Massachusetts on grounds of diversity. Named as defendants in the suit were Mr. and Mrs. Kirk, who at the time of the accident were the record owners of the property on which the injury occurred. Shortly after the applicable Massachusetts statute of limitations had expired,² plaintiffs learned that Mr. and Mrs. Mulrenin, rather than the Kirks, had actually been the owners of the property at the time of accident. Upon learning this fact, plaintiffs moved to amend their complaint by replacing the Kirks with the Mulrenins as the named defendants. However, since the Mulrenins had not been notified of the suit until after the statute had run, the district court held that the amendment was impermissible.³ The grounds for the court's holding were that the requirements set forth in Federal Rule of Civil Procedure 15(c)⁴ for the relation back of amendments had

¹ 508 F.2d 39 (1st Cir. 1974).

² In diversity actions, since federal courts must apply state substantive law, the same statute of limitations must be applied that would be applied if the case were being tried in state court because a statute of limitations has a direct substantive effect. *Guaranty Trust Co. v. York*, 326 U.S. 99, 110 (1945).

³ 508 F.2d at 40-41. According to the certificate on file in the appropriate town hall, Mr. and Mrs. Kirk were the owners of the business premises upon which the plaintiff-wife fell. In fact, however, the Kirks had sold the premises to Mr. and Mrs. Mulrenin several years before the accident occurred but had neglected to file, in violation of Massachusetts law, a notice of discontinuance. Mass. Gen. Laws ch. 110, § 5 (Supp. 1975). When plaintiffs instituted their suit, one month before the statute of limitations was due to expire, they relied upon the certificate in naming the Kirks as defendants. Not until after the statute had run did the plaintiffs learn that the Mulrenins had actually been the owners at the time of the accident. 508 F.2d at 41.

⁴ Fed. R. Civ. P. 15(c) provides in pertinent part:

An amendment changing the party against whom a claim is asserted relates back if . . . within the period provided by law for commencing the action against him, the party to be brought in by amendment (1) has received such notice of the institution of the action that he will not be prejudiced in maintaining his defense on the merits, and (2) knew or should have known that, but for a mistake concerning the identity of the proper party, the action would have been brought against him. . . .