American Standard, Inc. v Crane Co: The Insufficiency of Section 16(b)

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I. Section 16 (b) of the Securities Exchange Act of 1934

Section 16 (b) of the Securities Exchange Act of 1934 has outlived its usefulness. It has become a trap for unwary investors rather than a deterrent to speculative abuse by corporate insiders. The section has been especially unfair in application to complex transactions such as mergers. The futility experienced by federal courts in attempting to analyze complex transactions within the narrow framework of 16 (b) suggests its decrement as a factor in securities regulation.

At common law, corporate insiders were free to profit by trading on the basis of undisclosed information. It was felt that disclosure was not warranted when securities were bought and sold on exchange markets where there was no direct communication between buyer and seller. In Strong v. Repide, the Supreme Court created a minor exception with the "special circumstances" doctrine. In general, how-

1. Section 16(b) of the Securities Exchange Act of 1934 [hereinafter cited as the Act] provides in relevant part:
   For the purpose of preventing the unfair use of information which may have
   been obtained by such beneficial owner, director, or officer by reason of his re-
   lationship to the issuer, any profit realized by him from any purchase and sale,
   or any sale and purchase, of any equity security of such issuer . . . within any
   period of less than six months . . . shall inure to and be recoverable by the
   issuer, irrespective of any intention on the part of such beneficial owner,
   director, or officer in entering into such transaction. . . . 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 Com-
   mission by rules and regulations may exempt as not comprehended within the
   purpose of this subsection.
2. See 2 L. Loss, SECURITIES REGULATION 1037-38 (2d ed. 1961); H. MANNE,
   INSIDER TRADING AND THE STOCK MARKET 17-24 (1966); Cook & Feldman, Insider
5. The Supreme Court found that the defendant had a legal obligation to disclose
   all the "special circumstances" before purchasing the plaintiffs' stock. The defendant
   director of the Philippine Sugar Estates Development Company owned 30,400 of its
   42,030 shares outstanding. The defendant's agent purchased 800 shares from the

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ever, pre-1934 plaintiffs faced the insurmountable burden of proving a fiduciary relationship between directors or officers and their shareholders.  

The legislative history of section 16 (b) was replete with testimony exposing insiders' speculation and manipulation which had caused market fluctuations and had effectively discouraged valid investment. In enacting 16 (b), Congress realized that if proof were required, insiders could continue their devious practices and, except in the most blatant instances, take refuge behind an artificial wall of good faith. Experience with the common law remedy had convinced the legislators that actual proof of bad faith was a most difficult burden; thus a subjective approach based on intent was rejected. Instead, Congress established a regulatory mechanism with an objective standard imposing strict liability upon substantially all transactions occurring within the statutory time period, regardless of the intent of the insider or


7. Section 16(a) of the Act identifies insiders as:
Every person who is directly or indirectly the beneficial owner of more than 10 per centum of any class of equity security . . . or who is a director or an officer of the issuer of such security . . .


10. Id.


12. For the purpose of computing the six-month period, the date that a person becomes the “beneficial owner” of stock is the date on which he incurred an irrevocable liability to take and pay for the stock which was the closing date of an agreement binding both parties to the contract. Stella v. Graham-Paige Motors Corp., 232 F.2d 299, 301 (2d Cir.), cert. denied, 352 U.S. 831 (1956). “[T]he last day [of the six-month period] . . . is the second day prior to the date corresponding numerically to that of the first day of the period in the sixth succeeding month.” Stella v. Graham-Paige Motors Corp., 132 F. Supp. 100, 109 (S.D.N.Y. 1955).
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the existence of actual speculation. The section applies not only to directors and officers, but also to “beneficial owner[s]” who were deemed to exercise sufficient control over their companies to profit from undisclosed information. The six-month period represented a balance struck between the need to deter short-swing transactions based on inside information and a desire to avoid unduly inhibiting long-term corporate investment. Recovery of profits realized from short-swing transactions by insiders inures to the issuing corporation or its successor on the theory that inside information is a corporate asset and therefore profits derived from a misappropriation of that asset should be returned to the corporation.

The inexorable method of profit recapture contemplated by Congress was implemented by the Second Circuit in Smolowe v. Delendo Corp. In finding liability, the court matched the insiders’ highest sales and lowest purchases within six months “to achieve the showing of a maximum profit.” In keeping with the strict legislative purpose

13. This approach maximized the ability of the rule to eradicate speculative abuses by reducing difficulties in proof. Such arbitrary and sweeping coverage was deemed necessary to insure the optimum prophylactic effect.


In and out trading greatly magnifies the possibility of profit from inside information... and makes such profit [all] the more unfair because of the relatively risk-free character of a short-term commitment which the insider may make in anticipation of a favorable market development.


[T]he affirmative value of long-term personal financial commitments by insiders to the prosperity of the companies which they controlled was obviously great.


20. Id. at 237. In addition, the court decided that it would be unnecessary to require the identification of stock certificates actually purchased and sold. Insiders could easily circumvent an identification requirement by selecting those certificates held for
underlying the enactment of the section, the prophylactically imposed recapture method was designed to

squeeze all possible profits out of [insider] stock transactions, and . . . establish a standard so high as to prevent any conflict between the selfish interest of a fiduciary . . . and the faithful performance of his duty.21

A. Development of the Subjective Approach

1. Conversions. The objective Smolowe interpretation was applied to a conversion transaction in *Park & Tilford, Inc. v. Schulte.*22 Here the court used very broad language23 in finding liability on a record reflecting opprobrious conduct24 by the defendant corporate officers. It rejected the defendants' contention that the conversion had been "forced," noting that the defendants had made an "everyday business decision" when in complete control of the plaintiff corporation.25 On petition for rehearing, the defendants argued that no liability should attach since the common and preferred stock were equivalent in value. The court disagreed, citing the independent value of the preferred stock. Outside holding of the preferred was minimal, and there was no market for it. In addition, the sale of a large block of preferred would have depressed its price. The court concluded that this

more than six months as the certificates to be used for the second step of the short-swing transaction. Identification would as a practical matter prevent the recapture of profits from any sale followed by a purchase because it would be necessary to make the near impossible showing of the insider's subjective intent to conduct the connected phases of this type of short-swing transaction. See *Hemmer, Insider Liability for Short-Swing Profits Pursuant to Mergers and Related Transactions,* 22 VAND. L. REV. 1101, 1103 (1969).

21. 136 F.2d at 239.
23. [A] conversion of preferred into common stock followed by a sale within six months is a "purchase and sale" within the statutory language of § 16(b). Whatever doubt might otherwise exist as to whether a conversion is a "purchase" is dispelled by [the] definition of "purchase" . . .

Id. at 987. The court's reliance on the Act's over broad definition of "purchase" suggests that every conversion is a "purchase." An insider profiting would be subjected to liability if the conversion could be matched with a sale following within six months.

24. At a time when the value of the corporation's preferred shares was above the call price, the insiders exercised their control by arranging for the corporation to call the outstanding preferred at a given future date. The insiders converted their preferred into common and sold the common at a substantial profit within six months of the conversion. Id. at 986-87.
25. Id. at 987-88.
dilution of the preferred was not accurately reflected by the value on the same date of an equivalent amount of common stock.\textsuperscript{26}

Courts soon thereafter applied 16 (b) to other types of share exchanges. One district court took the literal approach, finding a purchase in a recapitalization involving a sale of the assets of subsidiaries to their parent pursuant to a merger.\textsuperscript{27} However, two later cases\textsuperscript{28} modified the objective trend of Smolowe and Park & Tilford. The first case found no sale in a transfer of shares of a third corporation by a corporate parent to its wholly owned subsidiary in exchange for the newly issued shares of the subsidiary.\textsuperscript{29} In the second case, Roberts v. Eaton,\textsuperscript{30} the court held that a reclassification of common stock into preferred and common was not a purchase, even though it had been designed to place the insider shareholders in a more advantageous selling position. In Eaton, Judge Clark eschewed the objective approach and the articulation of a hard and fast rule pertaining to all reclassifications.\textsuperscript{31} Instead, he adopted a more flexible subjective approach which utilized a threshold inquiry into the possibility for speculative abuse inherent in the particular reclassification before the court.\textsuperscript{32}

In Ferraiolo v. Newman,\textsuperscript{33} Judge (now Justice) Stewart observed that the subjective standard was emanating from the post-Park & Tilford cases.\textsuperscript{34}

The standard that emerges from these decisions can be simply stated: 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).\textsuperscript{35}

26. Id. at 990.
27. Blau v. Hodgkinson, 100 F. Supp. 361 (S.D.N.Y. 1951). The court placed emphasis on the insider's option to dissent from the exchange plan and receive cash instead. Id. at 373.
31. The court wished to avoid enunciating a "black-letter rubric" which would control subsequent reclassification cases. Id. at 85.
32. The court found that "[t]he reclassification . . . could not possibly lend itself to the speculation encompassed by § 16(b)." Id. at 86.
In *Ferraiolo*, the issuing corporation had called for a redemption of its preferred stock at a price $9 below the market price of its common stock. The insider who was a "very inactive director" and who had no influence on the timing of the redemption call was forced to convert or lose a sizable portion of his investment. Therefore, he converted his preferred into common as did 99 percent of the other shareholders and sold some of the common within six months of the conversion. The court distinguished *Park & Tilford* on control grounds noting that the *Park & Tilford* defendants had been in command of the issuer corporation and had directly caused the redemption call which had preceded their profitable conversion. The court found that the insider director had been forced into an involuntary conversion which neither created a new opportunity for profit nor contained the economic indicia of a purchase. Since the transaction "was not one that could have lent itself to the practices which Section 16 (b) was designed to prevent," the court reasoned that to avoid purposeless harshness 16 (b) would not apply. It emphasized that the characteristics shared by the preferred and common—both were readily marketable and neither could be diluted in value—made them economic equivalents and therefore no liability could attach for a conversion of one to the other.

After the Sixth Circuit's refinement of the "possibility of abuse" test, four other circuits considered the test. Three circuits accepted the test and applied it to conversion transactions. However, in *Heli-Coil Corp. v. Webster*, the Third Circuit dissented from the majority view. The eight judges sitting *en banc* split three ways on the question of liability. In order to eliminate the indebtedness of the Heli-Coil Corp. so that its balance sheet would "make a better statement," the defendant director converted his debentures into the common stock of

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36. 259 F.2d at 346.
37. Id.
38. Id. at 345. The Securities and Exchange Commission (SEC) vigorously argued the *Park & Tilford* rationale in its amicus brief supporting the plaintiff-appellant's petition for certiorari. In 1959 the General Counsel of the SEC published an article summarizing the SEC's objective stance. See Meeker & Cooney, *The Problem of Definition in Determining Insider Liabilities Under Section 16(b)*, 45 Va. L. Rev. 949, 961-65 (1959).
41. 352 F.2d 156 (3d Cir. 1965).
the company. After consulting with his investment banker and accountant concerning the economic and legal implications of a sale, the defendant sold approximately one-third of his common within six months of the conversion. The bare majority held that the conversion was both a sale of the debentures and a purchase of the common. Whereas the Webster majority applied the objective standard of Park & Tilford, the dissent preferred the "more discriminating analysis of Ferraiolo ... to the simplistic rule ... derived from Park & Tilford."

The Eighth and Ninth Circuits followed Ferraiolo and the Webster dissent. The facts of Petteys v. Butler were strikingly similar to those in Ferraiolo. The defendant was forced to convert his preferred stock into common stock since a redemption of the preferred was called at a price $10 below the market value of the common. The court, with Judge (now Justice) Blackmun dissenting, held that the insider’s sale of the common acquired on conversion was not within the purview of 16(b) since an examination of the facts indicated that there was no possibility of abuse. In Blau v. Max Factor & Co. the court held that a conversion of common into Class A common stock

42. Only four of the eight justices joined in the majority opinion.
43. 352 F.2d at 167. The court also held that no profit had been realized from the disposition of the debentures on conversion. Paper profits were not deemed to fall within the statutory definition of the terms "profit" and "realized." Only cash profits were included. Id. at 167-68. Contra, Newmark v. RKO General, Inc., 425 F.2d 348 (2d Cir.), cert. denied, 400 U.S. 854 (1971).
44. 352 F.2d at 161-62, 164.
45. Id. at 174 (Hastie, J., dissenting).
The choice . . . is between "a rule of thumb" . . . and a rule of reason designed to achieve a result that is both just and respectful of the legislative language and intendment.

Id. at 173-74.
48. 367 F.2d 528 (8th Cir. 1966), cert. denied, 385 U.S. 1006 (1967).
49. Either the statute means what it literally says or . . . it does not; . . . if the Congress intended to provide additional exceptions, it would have done so in clear language; . . . 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 application. The latter inevitably is a weakening process.

Id. at 538 (Blackmun, J., dissenting).
50. Id. at 535.
51. 342 F.2d 304 (9th Cir. 1965).
was not a purchase of the Class A stock even though the conversion was voluntary. The court noted that the two classes of common stock were clearly economic equivalents as evidenced by their full transferability and equal voting and liquidation rights. The court also pointed out that the transaction provided no new opportunity for speculative abuse, did not interrupt the continuity of the insiders’ investment and did not alter the risk assumed. This case was distinguishable from Ferraiolo and Petteys in that it involved a class of common stock convertible into another class of common stock rather than a senior security which is convertible into common stock. However, the court was not influenced by this distinction.

The Second Circuit agreed with the Eighth and Ninth Circuits in Blau v. Lamb. In Lamb, the defendant officer-director of Air-Way Industries, Inc. (Air-Way) transferred the stock of a second corporation to Air-Way in return for Air-Way’s newly created convertible preferred stock. The defendant’s personal holding company, the co-defendant and a beneficial owner of more than 10 percent of the Air-Way common stock, also received Air-Way’s preferred shares in a separate exchange. Both defendants converted to Air-Way common and sold within six months. The court’s examination of this complex intra-corporate merger led it to hold that the conversion of the preferred to common was not a sale of the preferred because of the economic equivalence of the preferred and common and the unchanged investment position of the defendants. In dicta, the court indicated the ineffectiveness of the objective approach when applied to complex transactions.

There is no rule so “objective” (“automatic” would be a better word) that it does not require some mental effort in applying it on the part of the person or persons entrusted by law with its application.

The federal courts’ treatment of conversion cases evolved from an objective to a subjective approach because of the need to both deter transactions fraught with the possibility of speculative abuse and yet

52. Id. at 309.
53. Id. at 306.
54. Id. at 308.
56. 363 F.2d 507 (2d Cir. 1966), cert. denied, 385 U.S. 1002 (1967).
57. Id. at 522.
58. Id. at 520.
preserve a measure of fairness to defendants. Unorthodox transactions were thought to be within the purview of section 16 (b) because the overly broad definitions of "purchase" and "sale" did not appear to include only routine cash transactions. Although most courts analyzing conversion transactions adopted the subjective approach, few appeared comfortable with it, as evidenced by the frequency of disagreement among circuit courts and between circuit courts and district courts. In order to establish uniformity of interpretation in conversion cases, the SEC promulgated rule 16b-9 which exempts any acquisition or disposition involving the conversion of one equity security into another. The rule, if deemed valid by the courts, purports to exempt nearly all conversions from the ambit of 16 (b) and thus bring to an end the tortuous judicial development in the conversion area.

59. The term "unorthodox transactions" refers to any non-cash transaction in which there is an exchange of securities (e.g., corporate reorganizations, acquisitions, reclassifications and conversions). See L. Loss, supra note 2, at 1069; Lang & Katz, Liability for Short-Swing Trading in Corporate Reorganizations, 20 Sw. L.J. 472, 475-76 (1966).
60. See note 11 supra.
61. Id.
63. See W. PAINTER, FEDERAL REGULATION OF INSIDER TRADING 42-52 (1968); Comment, Stock Exchanges Pursuant to Corporate Consolidations: A Section 16(b) "Purchase or Sale"?, 117 U. Pa. L. Rev. 1034 (1969).
65. 17 C.F.R. § 240. 16b-9 (1972). The rule provides in relevant part: Any acquisition or disposition of an equity security involved in the conversion of an equity security which, by its terms or pursuant to the terms of the corporate charter or other governing instruments, is convertible immediately or after a stated period of time into another equity security of the same issuer, shall be exempt from the operation of Section 16(b) of the Act . . . .
67. The SEC's power to promulgate an exempting rule is not a matter "solely within the expertise of the SEC and therefore beyond the scope of judicial review." Greene v. Dietz, 247 F.2d 689, 692 (2d Cir. 1957). In reviewing the validity of a former version of rule 16b-3, the Greene court stated that the test was "whether the rule was a proper exercise of the authority delegated to the Commission under [the] Act." Id. at 693. Cf. Keller Indus., Inc. v. Walden, 462 F.2d 388, 391 (5th Cir. 1972); Kornfield v. Eaton, 327 F.2d 263, 264-65 (2d Cir. 1964).
68. Hamilton, supra note 55, at 1476.
69. Rule 16b-9 followed a diverse collection of conversion cases that, taken together, establish no general proposition except the apparent futility of drafting any objective-type statutory provision that will insure against deciding
2. Terminating Merger Exchanges. The corporate merger area has become equally turbulent due in part to the murky precedent offered by the conversion cases. The major cause of courts' difficulty in applying 16(b) has been the recent ascendancy of share exchange tender offers as the most popular method of non-negotiated corporate acquisition. Prior to the middle 1960's, proxy contests were the most common method of corporate take-over. Later, cash tender offers were predominant. Then, as the stock market developed an affinity for conglomerates and growth companies, offers to exchange securities became the vogue. "The 'raiders' had begun to run out of cash and the commercial banks had become, at the urging of the Federal Reserve, less willing to finance 'raids.'" The evolution of corporate take-over methods to security exchange offers has compounded the confusion which courts had exhibited in conversion cases. Unlike conversion or intracorporate merger situations in which shares of the same corporate entity are exchanged, merger situations involve the exchange of the shares of different companies. Whether terminating share exchanges incident to a merger are purchases or sales for the purposes of 16(b) can be determined only by reference to the possibility-of-abuse test.

Newmark v. RKO General, Inc. first decided what factors constituted potential abuse in a terminating merger exchange. The court found the Blau v. Lamb "economic equivalence" analysis inapposite to an exchange involving "the securities of a different company." The difficult subjective questions. It would be comforting to assign these cases to the scrap heap. But that is impossible ....

5 L. Loss, supra note 66, at 3028.

70. The frequency with which conversion cases have been argued by analogy in merger cases has led Loss to predict that the conversion cases "may continue to rule us from their graves." Id. at 3029.

71. A tender offer may be defined as a public offer or solicitation by a company, an individual or a group of persons to purchase during a fixed period of time all or a portion of a class or classes of securities of a publicly held corporation at a specified price or upon specified terms for cash and/or securities.

Aranow & Einhorn, State Securities Regulation of Tender Offers, in The Tender Offer 41 n.1 (1972).


73. Id.

74. Id.

75. In this type of exchange the target company transfers all of its shares to the acquiring company in exchange for shares of the acquiring company at a predetermined exchange ratio.


77. Id. at 354.
Second Circuit observed a strong possibility for abuse in the defendant corporation's voluntary change of investment position while in complete control of the merger terms. Moreover, the defendant's advance knowledge of the timing of the terminating share exchange was termed a "classic example of trading while in the possession of information unavailable to the general public." The defendant's option to purchase was at a fixed price per share determined before the merger was made public. If the market dropped, the defendant could renounce the purchase. If the market stayed high, the defendant could coincide the timing of his transaction with the highest market value of the shares. In imposing liability, Judge Kaufman perceived the defendant's position to have been "Heads I win, tails I do not lose." Almost one year later, in Abrams v. Occidental Petroleum Corp., a New York federal district court found a lesser but sufficient degree of knowledge and control in the terminating merger share exchange of the corporate defendant. In analyzing a defensive merger situation the court remarked that the defendant's tender offer would be treated as a single act of purchase even though the shares had been tendered at different times. In finding liability, the court imposed the highest profit recovery in the history of 16(b)—$23,311,337.94.

B. Expansion of the Subjective Approach

Both the Second Circuit in Newmark and the Southern District of New York in Occidental utilized the subjective-possibility-of-abuse approach in examining terminating merger exchange sales. Two circuits expanded the subjective approach in cases involving option and deputization issues. In Bershad v. McDonough, the Seventh Circuit broadly construed 16(b) in scrutinizing an option agreement designed to avoid liability.

Transactions subject to speculative abuses deserve careful scrutiny. The insider should not be permitted to speculate with impunity.

78. Id. at 353-54.
79. Id. at 354.
81. Id. at 579.
83. 428 F.2d 693 (7th Cir. 1970).
merely by varying the paper form of his transactions. The commercial substance of the transaction rather than its form must be considered, and courts should guard against sham transactions by which an insider disguises the effective transfer of stock.84

The court adopted the lower court reasoning that the optionee's substantial down payment to the defendant was "tantamount to a sale."85 The Seventh Circuit found a contract for sale rather than an option agreement in light of the defendant's grant of an irrevocable proxy and transfer of two board seats to the optionee. Under these circumstances, the date of sale was found to have been the date the option had been purchased; not exercised.86 The opinion emphasized that formalistic attempts to evade 16 (b) should not be tolerated and that courts presented with such tactics should carefully examine the circumstances and facts before them. At no time, remarked the court, should a tribunal stop short of a careful fact analysis by applying the objective approach.87

Previously, the Second Circuit had reached the zenith of subjective fact analysis in a deputization case. In Feder v. Martin Marietta Corp.,88 the defendant corporation had "deputized" its president to be a director of the Sperry Rand Corporation. The president had authorized purchases of Sperry Rand stock both before and after his election to the Sperry Rand board. The court exhaustively probed the intent of the defendant corporation, finding that financial considerations had dictated its authorization of the directorship.89 In finding that inside information had flowed from Sperry Rand to defendant Martin Marietta through the deputy, the court reversed the lower court ruling that no deputization existed.90 The Feder court circumvented the Supreme Court's objective approach to the deputization issue in Blau v. Leh-

84. Id. at 697 (emphasis added).
85. In Bershad v. McDonough, 300 F. Supp. 1051, 1054 (N.D. Ill. 1969), the district court noted that the "binder" (down payment) amounted to approximately 14 percent of the total purchase price. The district court relied on Blau v. Allen, 163 F. Supp. 702, 705 (S.D.N.Y. 1958), in which that court recognized that a down payment amounting to 11 percent of the sale price "was not just a binder but constituted a substantial portion of the purchase price."
86. 428 F.2d at 698.
87. Id. at 697 n.5.
89. Id. at 264.
90. In Feder v. Martin Marietta Corp., 286 F. Supp. 937 (S.D.N.Y. 1968), the district court held that defendant Martin Marietta had not in fact deputized its president to sit on Sperry Rand's board of directors. The court noted that there had been no actual disclosure of inside information and that Martin Marietta's large purchase of Sperry Rand stock during the period of directorship was not controlling.
man, in which the Court had literally construed the meaning of "director" so as not to include defendant Lehman Brothers.

C. Return to the Objective Approach

In 1972, the Supreme Court again took the objective approach in literally construing the phrase "at the time of . . . sale." Reliance Electric Co. v. Emerson Electric Co. involved a split sale of stock by the defendant corporation in a defensive merger situation. The defendant corporation’s unsuccessful tender offer had left it with 13.2 percent of the target company’s stock. In order to avoid 16(b) liability, it reduced its holdings to 9.96 percent in one sale, then sold the remainder in a separate sale. The Court’s mechanical application of the 10 percent "beneficial owner" provision caused it to decline to examine the possibility of abuse inherent in a split sale. Justice Stewart, who had aggrandized the possibility-of-abuse approach 14 years before, spoke the majority’s unwillingness to examine the facts of the case. The Court’s reiteration of the objective interpretation of 16(b) was paradoxical. The 4-3 majority applied 16(b) mechanically "in harmony with the congressional design of predicking liability upon an ‘objective measure of proof.’" Yet, they sanctioned the defendant’s preexisting intent to avoid liability. In effect, the Court placed the 10 percent "beneficial owner" issue beyond the scope of its alternative construction formulation.

[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.]  

91. 368 U.S. 403 (1962). A partner of Lehman Brothers was a director of the Tidewater Associated Oil Company, having succeeded another Lehman partner on Tidewater’s board. At the time that its partner was a director, Lehman purchased and sold Tidewater securities at a profit. The Court construed the word "director" to refer to one partner, but not to the entire partnership. Id. at 410. Justice Douglas dissented, arguing that the Court’s decision “director” to refer to one partner, but not to the entire partnership. Id. at 410. Justice Douglas dissented, arguing that the Court’s decision “substantially . . . eliminate[s] ‘the great Wall Street trading firms’ from the operation of § 16(b) . . . .” Id. at 414.

93. See note 14 supra.
96. 404 U.S. at 424.
D. Beneficial Ownership

In contrast to the Supreme Court's strict construction in *Reliance*, two federal courts and the SEC had broadly interpreted the beneficial ownership issue prior to *Reliance*. In *Chemical Fund, Inc. v. Xerox Corp.*, the Second Circuit enunciated a "hypothetical conversion" test in granting a debenture holder's motion for declaratory judgment.

The total percentage of common stock which a holder would own following a hypothetical conversion of the Debentures it holds is the test of liability under section 16(b).

The court noted that the legislative history and purpose of the Act supported their reasoning. In addition, the court pointed out the "anomalous consequences" of treating the debentures by themselves as a "class of any equity security."

To hold that the beneficial owner of 10 percent or more of the Debentures is liable ... would ... impose a liability on an owner who by conversion of all his Debentures would obtain less than one-half of one percent of Xerox common stock. At the same time a holder of as much as 9 percent of Xerox common stock would not be liable. Thus Chemical Fund, able to command only 2.72 percent of Xerox common, would be liable for short-swing profits, although the holder of 9 percent of the common, more than three times Chemical Fund's total potential holding, would not be liable.

In mid-1968, the SEC adopted rule 16a-2(b) "to provide that, for the purpose of determining whether a person is a 10 percent beneficial owner, he shall be deemed to be the beneficial owner of securities of the class that he has the right to acquire 'through the exercise of presently exercisable options, warrants of rights or through the conversion..."
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of presently convertible securities.' The court in *Simon v. Sunasco* upheld the validity of both the hypothetical conversion test and rule 16a-2 (b). The court suggested that the beneficial owner referred to in both 16 (a) and 16 (b) was the same person, since these sections should be read together.

II. *American Standard, Inc. v. Crane Co.*

The courts' pendulations between an objective and subjective interpretation of 16 (b) has obscured its ever widening scope. The simple rule that Congress intended has grown to resemble a general anti-fraud provision. This unforeseen expansion has caused the anomalous application of a limited provision to an increasing number of investors. The plight of such investor-defendants is illustrated by the recent case, *American Standard, Inc. v. Crane Co.*

Defendant Crane Company desired to wrest control from the incumbent management of the Westinghouse Air Brake Company. Accordingly, Crane began purchasing Air Brake common stock on the open market in June, 1967. By January 26, 1968, Crane had acquired 10.08 percent of the outstanding Air Brake shares. On February 20th, Crane filed 14-B statements with the SEC, declaring its intention to solicit proxies to elect directors to Air Brake's board. During the week of April 8th, Crane mailed both a proxy statement and a tender offer to Air Brake shareholders. However, on June 7th, Air Brake and American Standard, Inc. merged. Pursuant to this merger, Crane

104. 5 L. Loss, *supra* note 66, at 3059.
106. 5 Rev. of Sec. Reg. 982 (Feb. 4, 1972).
108. Section 14(b) of the Act provides in relevant part:
It shall be unlawful . . . in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors, to give, or refrain from giving a proxy, consent, or authorization in respect of any security registered pursuant to section 78f of this title.
109. Crane publicly announced on April 6, 1968 its tender offer for all of the outstanding Air Brake shares. The tender offer was to expire on April 19, 1968, but was subsequently extended three times. By the terms of the tender offer, Crane proposed an exchange of stock and debentures totalling $50 in face amount for each share of Air Brake common. *See note 71 supra.*
110. The Air Brake-Standard merger was a classic example of a defensive merger. After Crane's initial purchases of Air Brake shares, Air Brake informed Crane on November 3, 1967, that it did not wish to pursue any merger discussion with Crane. On December 7, 1967, Air Brake amended its by-laws (it increased the minimum cumula-
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exchanged its Air Brake common shares for Standard convertible preference shares. On June 13th, Crane sold all but 10,000 of its Standard preference shares.

Plaintiff Standard sued to recover short-swing profits allegedly realized by Crane in violation of section 16(b). The district court found that opportunities for speculative abuse inhered in Crane's purchase and sale of Air Brake stock within a six-month period and granted plaintiff's crossmotion for summary judgment. Subsequently,

tive vote necessary to obtain representation on the board from 9.1 percent to 25 percent) to prevent Crane from obtaining representation on its board of directors. In mid-December, 1967, Standard made its initial overture to Air Brake through its investment banking representative, Blyth & Company. On February 19, 1968, Standard, through Blyth, proposed a detailed merger exchange to Air Brake. On March 4, 1968, Air Brake and Standard agreed to merge, subject to shareholders approval on May 16, 1968. Notwithstanding the March 4, 1968 Air Brake-Standard agreement to merge, Crane continued purchasing shares on the open market and mailed its proxy solicitations and tender offer. The more shares and proxies received, the better would be Crane's chances of defeating the Air Brake-Standard merger on May 26, 1968. However, on the day that Crane's tender offer was to expire (April 19, 1968), Standard manipulated the price of the Air Brake stock. Standard purchased 170,000 shares of Air Brake stock on the New York Stock Exchange at an average price of $49.50. Standard sold 100,000 shares to Investors Diversified Services, Inc. off the market (Standard's telegram to IDS confirming the sale was marked "Highly Confidential") and 20,000 shares on the market to Dillon Read & Co. The sales were at a negotiated average price of $44.50. Standard lost over $500,000 on its transactions for the day. Standard's extraordinary buying, coupled with its secret sales off the market, inevitably distorted the market picture and deceived public investors, particularly the Air Brake shareholders. Once the price of Air Brake stock (which had opened at $45 1/4) reached $50, Crane's tender offer was doomed to fail. At this point, Crane accelerated its open market purchasing and turned to the courts for relief. From April 29 to May 24, 1968, Crane purchased an additional 491,861 shares at a cost of over $24,000,000. Nevertheless, on May 26, 1968, the Air Brake shareholders voted (2,903,869 to 1,180,298) to approve the merger with Standard. Meanwhile from May 21 to June 3, 1968, the District Court for the Southern District of New York held a trial on the merits. On June 5, 1968, the court dismissed Crane's consolidated complaint, enabling the Air Brake-Standard merger to be formalized two days later.

111. At the date of the Air Brake-Standard merger, Crane held 1,480,623 shares of Air Brake common. In the Air Brake-Standard merger exchange, Standard issued one share of a new convertible preference stock (worth $4.75) for each two Air Brake shares. Each share of the Standard preference stock was convertible into 2% shares of Standard common stock. Wall Street Journal, June 11, 1968, at 6, col. 2. Thus, between June 7th and June 13th, Crane received 740,311 shares of Standard convertible preferred for its 1,480,623 shares of Air Brake common. Had Crane converted, it would have had approximately 1.97 million shares of Standard common.

112. Crane received $76,134,921.75—a profit of over $10,000,000. Instant case at 1156.

113. Two former Air Brake shareholders consolidated their complaints with American Standard.


115. In support of its motion for summary judgment, Crane argued that Standard's manipulative trading activities collaterally estopped Standard from recovery. In addi-
however, the district court withdrew its opinion to consider the possible impact of Abrams v. Occidental Petroleum Corp. In a supplemental opinion the district court held that Occidental did not bar the prior disposition of the case and furthermore that Crane's new motion for summary judgment was without merit.

A. Rationale of the Decision

Before reviewing Crane's motion, the court assessed the impact of Abrams v. Occidental Petroleum Corp. upon its earlier decision. At the beginning of its supplemental opinion, the court noted the similarity in facts between the two cases. In each case, a defensive merger left an unsuccessful take-over bidder with a competitor's shares. The court pointed out that one major distinction lay in the Occidental defendant's grant of an assignable option to its competitor for control of the target company. The competitor's option was to buy the stock which the defendant, Occidental Petroleum Corporation, would receive in the merger exchange. However, the court was "primarily concerned" with Occidental's ruling that no possibility of speculative abuse inhered in Occidental Petroleum's transactions.

The Second Circuit's decision in Newmark v. RKO General, Inc provided the focal point for both decisions. The RKO General court decision, Crane argued that its "illegally forced" transaction was not a purchase or sale within the meaning of 16(b). In opposition, Standard contended that Crane's estoppel argument was incorrect as a matter of law. Also, Standard argued that 16(b) applied on its face to Crane's transactions because of Crane's insider status and purchase and sale of the Air Brake common stock within six months. Standard asserted that at the very least Crane was not entitled to summary judgment because there remained disputed questions of material fact concerning the alleged forced sale. Instant case at 1157.


117. Crane's new motion for summary involved the exemption and registration provisions of the Act. See notes 131-38 infra and accompanying text.

118. 450 F.2d 157 (2d Cir. 1971).

119. Instant case at 1166.

120. Id.

The option could be exercised at any time after December 9, 1967—six months and one day after Occidental's last contemplated acquisition of [the target company] shares.


121. Instant case at 1166.

found the corporate defendant liable due to its excessive knowledge of the timing and control of the terms of a merger.\textsuperscript{123} RKO General actually knew of the imminent merger announcement that would enhance the price of the shares and could largely control its course. In contrast, the instant opinion noted that the \textit{Occidental} defendant had insufficient knowledge to predict that a defensive merger would occur and was unable to influence the terms of the exchange offer.

We fail to see the possibility of speculative abuse in a situation where such an offeror simply declines to make a still higher offer or to attempt to block a transaction which it regards as advantageous to all the stockholders including itself.\textsuperscript{124}

The instant court's concurrence in this distinction did not lead it to suggest that Crane's knowledge paralleled that of the \textit{RKO General} defendant, although it did accept Standard's contention that Crane consciously sought to realize windfall profits whether or not a take-over of Air Brake ensued.

Since nearly all merger announcements bring about a rise in the market price of a merging company, Crane stood to win and knew it stood to win, whether or not it acquired control of Air Brake.\textsuperscript{125}

Likewise, the earlier opinion had found a strong possibility of speculative abuse in light of Crane's ability to control the merger exchange.

Crane ... did not possess the array of control powers exercisable by RKO .... 
... [Nevertheless] there were ... significant ways in which Crane could influence the course of events. For example, ... by the terms of its own tender offer.\textsuperscript{126}

Nonetheless, the court had "serious doubts" whether Crane's liability could stand on speculative abuse grounds in light of \textit{Occidental}.\textsuperscript{127} This seeming impasse did not trouble the court, since liability could be established by Crane's \textit{cash sales} alone.

In the earlier proceeding, Standard had posited the alternative argument that Crane's cash sale of the Standard preferred constituted

\begin{itemize}
\item \textsuperscript{123} See notes 78-79 \textit{supra} and accompanying text.
\item \textsuperscript{124} Instant case at 1167, quoting 450 F.2d at 163.
\item \textsuperscript{125} Instant case at 1159 (emphasis added). See \textit{Takeover Bids, supra} note 72, at 252.
\item \textsuperscript{126} Instant case at 1161.
\item \textsuperscript{127} Instant case at 1167. Specifically, the court was troubled by \textit{Occidental}'s extension of the possibility-of-abuse approach to the exchange of shares of another company pursuant to a merger.
\end{itemize}
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a "sale." Standard's major contention was that Crane's sale on conversion of the Air Brake common was a "sale" which lent itself to speculative abuse. Thus, for the purposes of Standard's crossmotion for summary judgment, the court in its earlier opinion relied upon the intimate conceptual relationship between a sale on conversion and the strong possibility of abuse inherent in that type of sale. But in its supplemental opinion, the court pointed out that where a cash sale is involved, the insider's liability was clear unless the sale was forced.\textsuperscript{128} The court emphasized that the holding in \textit{Occidental} did not influence its earlier holding that Standard's acts had not forced Crane to sell "when it did."\textsuperscript{129} To buttress this conclusion, the earlier opinion had cited three cases in which recovery had been allowed against "forced sellers of sorts."\textsuperscript{130}

After deciding that \textit{Occidental} did not bar its earlier holding, the court considered Crane's new motion for summary judgment. In its new motion, Crane contended that the Standard preference stock received in the merger was both temporarily exempted and not effectively registered. The court conceded that Crane's "ingenious . . . technical arguments" raised "doubts as to the construction of the statute and various SEC rules."\textsuperscript{131} Nevertheless, the court dismissed these argu-

\textsuperscript{128} Instant case at 1168.
\textsuperscript{129} With reference to the forced sale issue, the earlier court held that neither the prior litigation between the parties, nor the estoppel doctrine precluded Standard from recovery. The prior litigation had involved Crane's claims under §§ 9(a)(2) and 10(b)(5) of the Act. Crane had argued that Standard had illegally solicited proxies and had manipulated the trading of the Air Brake common stock. A district court dismissed both actions two days before the Air Brake-Standard merger. \textit{See} note 110 \textit{supra}.

In Crane Co. v. Westinghouse Air Brake Co., 419 F.2d 787 (2d Cir. 1969), the Second Circuit affirmed the district court's dismissal of the proxy claim, but found for Crane on the manipulation issue. The court held that for purpose of equity jurisdiction, Crane had standing to sue as a seller. \textit{Id.} at 798-99. On remand, however, the district court held that no damages could be awarded to Crane without a jury trial, because there remained a disputed question of material fact concerning Standard's intent. Crane Co. v. American Standard, Inc., 326 F. Supp. 766, 775 (S.D.N.Y. 1971). The instant court agreed, reasoning that a jury might possibly find for Standard. The court held that the preceding courts had made no finding of fact that Standard's acts had compelled Crane to sell. Instant case at 1161-63.

The major reason for the instant court's rejection of Crane's estoppel argument was the difference in the issues in the prior litigation (Crane's standing as a seller) and in the instant case (Crane's status as a forced seller). The court also applied the "but for" test and found Standard causation lacking. Finally, the court emphasized that there was a fatal deficiency in the evidence concerning Standard's control of the timing of Crane's sale. Instant case at 1163-64.


\textsuperscript{131} Instant case at 1173. Crane's contention that the Standard preference stock
ments, noting the possible chaos that would be created otherwise. The court pointed out that Crane's motion if successful would permit insiders to

trade in unregistered convertibles and derive all the advantages of the publicly traded underlying stock all the while being insulated from § 16(b) liability because of the convertible's unregistered status. 132

The court rejected Crane's exemption argument because, if successful, it would defeat the "monolithic purpose" of 16(b) to make insider dealing unprofitable. 133 Thus, the court accepted Standard's contention that the specific provisions advanced by Crane "carve out ... only limited exemptions ... not general exemptions from the entire Act or from § 16(b) in particular." 134

In rejecting Crane's non-registration contention, the court utilized the Chemical Fund hypothetical conversion test. 135 Crane had argued that this test was inapplicable for two reasons: first, the Standard preference and common stock were not economically equivalent; and second, the Standard preference was itself a "class of any equity security." 136 Although admitting that the hypothetical conversion test might not be applicable to all cases involving convertible debentures, the court ap-

was both an exempted and an unregistered security was based on two SEC rules—rule 12b-6 and rule 12a-5. Crane first argued that the registration of the Standard preference stock became effective on July 12, 1968. Crane cited rule 12b-6 as authority for this proposition.

A class of securities with respect to which a registration statement has been filed pursuant to section 12 of the act shall be deemed to be registered for the purposes of sections 13, 14, 15(d) and 16 of the act ... only when such statement has become effective as provided in section 12 and securities of said class shall not be subject to sections 13, 14 and 16 of the act until such statement has become effective as provided in section 12.

17 C.F.R. § 240.12b-6 (1972) (emphasis added). Crane argued that in June, 1968, Standard's registration (filed on May 6, 1968) had not yet become effective. The second prong of Crane's argument was that the Standard preference stock was an "exempted security" until its registration became effective on July 12, 1968. Crane cited both rule 12b-6 and rule 12a-5 as authority. Rule 12a-5 grants a temporary exemption from the registration requirements of § 12(a) of the Act for any security issued as a substitute for another security (the "original security") which had theretofore been admitted to trading on the exchange. Crane reasoned that the Air Brake stock, which had been admitted to trading on the New York Stock Exchange, constituted the "original stock" for which the Standard preference stock was substituted as a result of the merger. The Standard preference stock thus qualified for an exemption under rule 12a-5. Supplemental Brief for Defendant at 34-40, American Standard, Inc. v. Crane Co., 346 F. Supp. 1153 (S.D.N.Y. 1972).

132. Instant case at 1173.
133. Id. at 1169.
134. Id.
135. See note 100 supra and accompanying text.
136. See note 101 supra.
plied the test on the basis of Crane's "right to acquire" more than 10 percent of the common stock through conversion. The court cited *Simon v. Sunasco* as authority that Crane was the "beneficial owner" of the underlying American Standard common.

**B. Considerations Ignored by the Court**

The instant court was confronted by a dilemma familiar to its predecessors. On one hand, merger transactions frequently provide the opportunity for speculative abuse. But, on the other hand, 16(b) was clearly not designed to apply to defensive merger situations in which the unsuccessful take-over bidder finds itself irrevocably entitled to the shares of its successful competitor. The result of applying 16(b) to such complex transactions is to magnify the harsh impact of the re-capture provisions upon the insider's merger exchange of shares. The imposition of 16(b) liability upon the victim of a defensive merger will be unfair as well as harsh unless a court examines all the facts and circumstances surrounding a particular transaction.

The instant court's examination of Crane's transactions was selective rather than comprehensive. In its supplemental opinion, the court observed that Crane's knowledge and control of the timing and terms of the Air Brake-Standard merger was the "indispensable predicate" to its holding that the possibility of speculative abuse had existed. In its earlier opinion, the court cited the remarks of a former SEC Chairman as authority for its inference that Crane's purchases of Air Brake stock made after the March 5, 1968 announcement of the Air Brake-Standard preliminary merger agreement had been knowingly designed to reap a speculative harvest.

There has been enough experience . . . for any sophisticated take-over bidder to know that, unless [target] management joins him, [target] management will seek another partner and that other partner will make a slightly better offer. We have the feeling that many of these [take-over bidders] are doing it for the short-term gain, or, to use the vernacular, to make a fast buck.

137. See notes 103-04 supra and accompanying text.
138. See note 105 supra and accompanying text.
139. See notes 19-21 supra and accompanying text.
However, the court did not acknowledge that other Air Brake shareholders as well as the general public were free to purchase Air Brake shares at any time prior to the consummation of the merger. More important, the court ignored the manifest probability that Air Brake and Standard might never have merged. On September 27, 1967, Air Brake’s management consultant reported that the trend of Crane’s and Standard’s earnings was similar and that the plumbing industry (in which Crane and Standard were competitors) was less dynamic than the industry participated in by Air Brake.  

In addition, the court failed to mention the general principle that target companies look upon defensive mergers as a last resort and are usually reluctant to bind themselves until a thorough examination of the new offeror’s books can be made. The tenuous nature of the projected Air Brake-Standard merger provided Crane with a good reason to continue purchasing Air Brake shares. Even though Standard’s manipulative trading activity of April 19, 1968 had subverted Crane’s tender offer, Crane’s institution of legal action and accelerated open market purchasing could well have enabled it to achieve victory at the May 26th, 1968 Air Brake shareholder’s meeting. Thus, an analysis of the court’s omissions suggests that the court underestimated Crane’s take-over ability while overestimating the possibility of speculative abuse inhering in Crane’s alleged insider knowledge.

With reference to control, the earlier court suggested that Crane could affect the exchange ratio of the Air Brake-Standard merger by the terms and timing of its tender offer. Not mentioned was the obvious fact that it would be nearly impossible for any tender offeror not to affect the exchange ratio of a subsequent merger. The earlier court also submitted that Crane had the ability to “influence the speed and timing of the merger and possibly its outcome.” The court elided

145. See note 110 supra.
146. Instant case at 1161.
Crane's actual ability to prevent or delay the merger. Instead, the court noted:

[O]ur search is not to determine whether Crane intended these results, but whether they were possibilities which inhered in the situation.\textsuperscript{148}

The court's most glaring omission concerned the Occidental defendant's ability to avoid 16 (b) liability through its special knowledge and effective control. In early May, 1967, the defendant Occidental Petroleum Corporation made a cash tender offer to purchase 500,000 shares in the Kern County Land Company (Old Kern).\textsuperscript{149} The offer was widely accepted by the Old Kern shareholders. By May 10th more than 500,000 Old Kern shares had been tendered, so that Occidental Petroleum had become the beneficial owner of more than 10 percent of the common stock of Old Kern and thus subject to the requirements of sections 16 (a) and (b) of the Act.\textsuperscript{150} On May 19th, the Tenneco Corporation offered, and Old Kern unanimously accepted, an exchange package 23 percent greater than Occidental Petroleum's.\textsuperscript{151} Realizing that it had little chance of winning the contest for Old Kern shares, Occidental Petroleum initiated two mandamus actions in the Superior Court of California, seeking extensive inspection of Old Kern's books and records.\textsuperscript{152} Prior to a ruling by the California court, Old Kern voluntarily granted Occidental Petroleum access to its non-public documents.\textsuperscript{153} For six days, an Occidental Petroleum team of five lawyers and accountants examined such non-public documents as Old Kern's general ledger, consolidating financial statements, consolidating journal entries and details of cash receipts from oil operations.\textsuperscript{154}

\textsuperscript{148} Id.

\textsuperscript{149} Abrams v. Occidental Petroleum Corp., 450 F.2d 157, 158 (2d Cir. 1971), cert. granted sub nom. Kern County Land Co. v. Occidental Petroleum Corp., 405 U.S. 1064 (1972). The offering price was $83.50 per share. An additional $1.50 per share would be paid to transmitting brokers.

\textsuperscript{150} Id. at 159.

\textsuperscript{151} Tenneco proposed that Old Kern transfer its assets to Tenneco's newly owned subsidiary (New Kern). In exchange Tenneco offered a new $5.50 preference voting stock convertible into 3.6 shares of Tenneco common stock. The Tenneco package was valued at approximately $105 per share. Id. at 159.

\textsuperscript{152} Id.

\textsuperscript{153} Petitioner's Brief for Certiorari at 5-6, Kern County Land Co. v. Occidental Petroleum Corp., 405 U.S. 1064 (1972).

\textsuperscript{154} Id. at 6.
Occidental Petroleum's use of its favorable stock position to secure a special and very profitable arrangement for itself in the form of the option agreement stands in stark contrast to Crane's fruitless attempt to avoid 16 (b) liability. The option agreement enabled Occidental Petroleum to "see to it that the matching transaction [was] postponed beyond the six months period . . . ." In contrast, the instant court in its supplemental opinion emphasized that Crane's purchase of the Air Brake common, matched against its cash sales of the Standard preferred, did not fall within the "uncovered category carved out by Occidental." Rather, such cash transactions were a "garden-variety purchase and sale" to which the section is objectively applied. In applying the "crude rule of thumb" to Crane's cash sale, the court chose not to address Crane's "issuer" argument.

Subdivisions (a) and (b) of § 16 are grammatically interconnected and must, therefore, be read together. So far as here pertinent, they provide:

"Sec. 16. (a) Every person who is . . . . the beneficial owner of more than 10 per centum of any class of any equity security . . . . , or who is a director or an officer of the issuer of such security, shall file specified reports of the amount of all equity securities of such issuer of which he is the beneficial owner . . . .

"(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 . . . . within any period of less than six months . . . . shall inure to and be recoverable by the issuer . . . . Suit to recover such profit may be instituted . . . by the issuer, or by the owner of any security of the issuer in the name and in behalf of the issuer . . . ." (Emphasis added)

The language is plain. The statute proscribes short-swing profits from the purchase and sale by an insider of any equity security of "such issuer." The statute thus deals with a single issuer, not with two. An equity security of "such issuer" must be the subject of both the purchase and the sale. The statute does not, therefore, embrace the purchase of stock in one issuer and the sale of stock in

155. Id. at 31.
156. 450 F.2d at 162.
157. Instant case at 1167.
158. Id., quoting 450 F.2d at 162.
another. It does not permit the matching of Crane's purchases of [Air Brake] stock against its sale of Standard stock.169

The instant court's broad reading of RKO General along with its narrow reading of Occidental caused it to reject this and other "ingenious technical arguments" mounted by Crane. Occidental's narrow reading of RKO General and conclusion opposite that in the instant case indicate that a panacea from outside the federal courts must be sought. Congress, realizing that the mechanical application of 16 (b) could cause purposeless harshness,160 specifically granted authority to the SEC to exempt transactions which fall within the letter, but not the spirit of 16 (b). This broad power to adopt "rules and regulations" exempting transactions which are "not comprehended" within the purpose of 16 (b) is exercised sparingly.161 Therefore, if the congressional purpose underlying 16 (b) is to be properly implemented one might conclude that the federal courts must temper the injustices caused by 16 (b) through a flexible and pragmatic case-by-case analysis.162 However, as evidenced by the instant case, courts confronted with complex corporate transactions have experienced difficulty in enunciating a general rule which would both restrict 16 (b) liability to those transactions falling within its purpose and serve as a clear guide to corporate insiders and their counsel.163 Thus, it is arguable that lodging the exemptive power in the SEC rather than the courts has several advantages. The certainty implicit in an SEC rule not only would provide greater fairness in the form of recognizable guidelines, but would also preserve the deterrent effect of 16 (b).164 In addition,
the lack of uniformity among circuits and between circuit and district courts165 would be alleviated by a definitive SEC rule.

The instant court did not mention the SEC's rulemaking power as a possible solution to the 16 (b) merger problems. One probable reason for this was the dubious authority recommending such a policy.166 Another likely reason for the court's silence was the SEC's denial of proposed rule 16b-11 which had been requested by the Occidental defendant.167 The SEC declined to promulgate the proposed rule, which would have exempted unsuccessful tender offerors, because the Williams Bill was then pending before Congress.

The Williams Act168 (also not mentioned by the court) was originally designed to regulate cash tender offers. Prior to 1970, this Act required a purchaser of 10 percent of the equity securities of a public company to disclose his plans with respect to the stock. In addition, the purchaser had to disclose any contracts or arrangements made in furtherance of his design to acquire a target company. As of 1970, the Williams Act applies to 5 percent purchasers and to share exchange tender offers as well as cash tender offers.169 The court also omitted mention of another potentially useful device to privately enforce tender rules—section 10 (b) 170 of the Act and rule 10b-5171 thereunder. In con-

165. See note 64 supra.
166. In Heli-Coil Corp. v. Webster, 352 F.2d 156, 165-66 (3d Cir. 1965), the majority maintained that Congress had
confided to the [SEC] rather than to the Courts the difficult task of determin-
ing those particular circumstances which would justify the exemption of certain
transactions from the purview of the statute.
Id. at 166. The authority of Webster has, however, been seriously eroded outside the
Third Circuit.
167. See Abrams v. Occidental Petroleum Co., 450 F.2d 157, 160 (2d Cir. 1971);
168. §§ 13(d)-(e), 14 (d)-(f) of the Act, 15 U.S.C. §§ 78m(d)-(e), 78n(d)-(f)
§§ 78m, n (1964).
170. Section 10(b) of the Act provides in relevant part:
It shall be unlawful for any person, directly or indirectly . . . To use or
employ, in connection with the purchase or sale of any security . . . any
manipulative or deceptive device or contrivance in contravention of such rules
and regulations as the Commission may prescribe as necessary or appropriate
in the public interest or for the protection of investors.
171. Rule 10b-5 provides:
It shall be unlawful for any person, directly or indirectly, . . .
(1) to employ any device, scheme, or artifice to defraud
(2) 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
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Contrast to section 16 (b), rule 10b-5 is a flexible and very potent bar to the speculative abuse of confidential information by corporate insiders.\textsuperscript{172} The sweeping holding in \textit{SEC v. Texas Gulf Sulphur Co.}\textsuperscript{173} may well become the principal basis for all actions grounded upon a theory of insider abuse of confidential corporate information.

CONCLUSION

The last chance to disembroil section 16 (b) may well rest with the Supreme Court which granted certiorari in the \textit{Occidental} case on April 17, 1972.\textsuperscript{174} The Fourth Circuit's order deferring final disposition of \textit{Gold v. Scurlock}\textsuperscript{175} until the Supreme Court rules in \textit{Occidental}, highlights the importance attached to the Court's prospective decision. It is very possible that the Court will lay down a hard and fast rule concerning defensive mergers if the methodology of \textit{Reliance Electric Co. v. Emerson Electric Co.}\textsuperscript{176} is followed. The \textit{Reliance} Court's tacit approval of the defendant's split sale method of avoiding liability\textsuperscript{177} could indicate that Occidental Petroleum's option device will not be exhaustively probed.\textsuperscript{178}

If, however, the Court holds against Occidental Petroleum, the policy implications would be far-reaching. An additional weapon would be placed in the target company's hands.

\begin{itemize}
\item the circumstances under which they were made, not misleading, or
\item (3) 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.
\end{itemize}


172. Lowenfels, supra note 160, at 61.

173. 401 F.2d 833 (2d Cir. 1968), cert. denied, 394 U.S. 976 (1969). The Second Circuit determined that insiders of the Texas Gulf Sulphur Company violated rule 10b-5. The insiders had purchased company stock on the basis of undisclosed information regarding highly favorable drilling results in a remote area.


177. \textit{See} notes 92-96 supra and accompanying text.

178. In \textit{Reliance}, the Court analogized the six months limitation to the 10 percent requirement.

[A] "plan" to sell that is conceived within six months of purchase clearly would not fall within § 16(b) if the sale were made after the six months had expired, and we see no basis in the statute for a different result where the 10% requirement is involved.

404 U.S. at 423.
The target . . . not only may solicit a better offer . . . but also may deliver as bait to the [defensive merger offeror] a substantial § 16(b) liability on the part of the very offeror whose initiative aroused the target from its seeming torpor and created a large profit for all the stockholders . . . .

Such a decision would cause great uncertainty among potential litigants due to the lack of a definitive rule in the defensive merger area. Likewise, in the absence of Supreme Court guidance lower federal courts will continue to be constrained by an antiquated legislative enactment.

 Whatever the result, it will be determinative of Crane's fate on appeal to the Second Circuit. If the Supreme Court adopts Judge Friendly's underlying ground of decision—that it is repugnant to considerations of equity to exclude from profits "the person [or company] who pointed the [target] company down the road to good fortune"—Crane's prospects for reversal will be enhanced. For, although the instant court in its earlier decision pointed out that "courts do not favor the defense of equitable estoppel . . ." there remains the indisputable fact that Standard's market manipulation was rewarded, not punished.

Regardless of the Supreme Court's disposition of Occidental, the opportunity remains for the SEC to preempt the Court in the defensive merger area. However, this is unlikely in view of the SEC's past reluctance to invoke its rulemaking power. While the SEC will invariably continue to assist courts by filing amicus curiae briefs, it is doubtful that the Commission will formulate a new rule. Thus, the onus is upon the Supreme Court.

WILLIAM J. FLYNN, III

179. Abrams v. Occidental Petroleum Corp., 450 F.2d 157, 163-64 (2d Cir. 1971). The Second Circuit remonstrated against such a result. Judge Friendly observed that an unyielding approach to defensive merger situations would discourage bona fide tender offers "which would operate to the great benefit of stockholders of the target corporation." Id. at 164.


181. 450 F.2d at 164.
