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SECTION 16(b) AND "EXTRAORDINARY" TRANSACTIONS:
CORPORATE REORGANIZATIONS AND STOCK OPTIONS†

Robert Todd Lang* and Melvin Katz**

I. Introduction

Forty years have passed since the enactment of Section 16(b) of the Securities Exchange Act of 1934,1 a remedial measure designed to remove the profit incentive from insider trading. Section 16(b) provides that any profit realized during a six-month period by statutory insiders (officers, directors and the holders of more than 10% of a class of equity securities) from any combination of purchase and sale2 of the issuing corporation’s equity securities must be disgorged to the issuer. The statute applies to each issuer which has one or more classes of equity securities listed on a national securities exchange or registered under Section 12(g) of the Exchange Act.3

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1 The language of § 16(b) is as follows:

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 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.


2 Each reference herein to a purchase followed by a sale shall be deemed to include a sale followed by a purchase.

3 Section 12(g) of the Exchange Act requires an issuer, with assets exceeding $1,000,000 and a class of equity security not listed on a national securities exchange but held of record by at least 500 persons, to register such security under the Exchange Act. 15 U.S.C. § 78l (g) (1970). This subjects the issuer to the proxy rules, see SEC Reg. 14A, 17 C.F.R. §§ 240.14a-1 to 240.14a-103 (1973), and the periodic reporting requirements of § 13, 15 U.S.C. § 78m (1970), as well as subjecting its insiders to § 16.

Section 16(b) refers to "such beneficial owner, directors or officer." 15 U.S.C. § 78p(b) (1970) (emphasis supplied). This requires reference to the language of § 16(a) in order to determine the categories of persons to which § 16(b) applies. Section 16(a) speaks of any "person who is...the beneficial owner of more than 10[%] of any class of any equity security...which is registered pursuant to section 12..." 15 U.S.C. § 78p(a) (1970). The full text of § 16(a) and a description of the reports which must be filed thereunder appear at note 181.1 infra. In the case of an officer or a director, if the issuer has but one class of equity security registered, § 16(b) applies also to their transactions in its unregistered classes. 2 L.
When originally enacted, the statute was intended to squeeze out any profits derived by insiders from short-swing trading in the equity securities of their own companies without requiring proof of abuse of inside information or the motive of the insider in purchasing or selling the securities. With respect to conventional cash transactions, Section 16(b) has presented relatively few problems which have not been resolved either by the courts or, in certain technical areas, by

4 The section has been described as "a crude rule of thumb." Statement of Thomas G. Corcoran, Esq., Hearings Before the Senate Comm. on Banking and Currency, 73d Cong., 2d Sess. 6557 (1934).

5 One area in which the application of § 16(b) has produced some uncertainty concerns the attribution of director or officer status to an entity one of whose members is a director or officer of the issuer. The first case to even hint at such a possibility was Rattner v. Lehman, 193 F.2d 564 (2d Cir. 1952), where Judge Learned Hand recognized the possibility of liability on the part of a firm which had "deputed a partner to represent its interests as a director on the [issuers'] board . . . ." Id. at 567.

The Supreme Court in Blau v. Lehman, 368 U.S. 403 (1962), gave viability to the deputization theory, although the Court found it inapplicable to the case under consideration. The Court acknowledged that the provisions of the Exchange Act permit a partnership to be deemed a director for § 16(b) purposes. However, the language used was somewhat more limited than that used by Judge Hand, i.e., liability would be imposed upon the partnership if it "actually functioned as a director through . . . [the partner], who had been deputized by . . . [the partnership] to perform a director's duties not for himself but for . . . [the partnership]." Id. at 410.

The evidence in Lehman indicated that Thomas, a partner in Lehman Brothers, had succeeded Hertz, also a partner in Lehman, as a director of the issuer, Tide Water. Hertz joined Tide Water thinking it to be in the interests of Lehman Brothers. For the same reason, Hertz suggested Thomas as his successor. Thomas had never discussed the operating details of Tide Water with any other partner of Lehman Brothers. Lehman's purchasing of Tide Water shares was predicated solely upon public announcements made by the issuer. Thomas was unaware of Lehman's intent to purchase shares of Tide Water until after the transactions had been consummated. Under these facts, the Court found that Thomas was not a deputy of Lehman Brothers.

The signal case in the evolution of the deputization doctrine was Feder v. Martin Marietta Corp., 406 F.2d 260 (2d Cir. 1969), cert. denied, 396 U.S. 1036 (1970), where the Second Circuit reversed the district court and found that George M. Bunker, President and Chief Executive of Martin Marietta, had been deputized by Martin Marietta to serve as a director of the Sperry Rand Corp. The Second Circuit indicated five evidentiary factors which led to its finding that the determination by the district court was "clearly erroneous." First, Bunker testified that he was ultimately responsible for the total operation of Martin Marietta, including personal approval of all purchases of Sperry shares. Secondly, Bunker had been furnished with information concerning Sperry's financial outlook and had discussed Sperry's affairs with officials at Martin Marietta pursuant to a review of the latter's investment in the former. Thirdly, Bunker's letter of resignation stated that his presence on the Board of Directors of Martin Marietta was due to the belief of Sperry officials "that the Martin Marietta ownership of a substantial number of shares of Sperry Rand should have representation on . . . [the Sperry] Board." 406 F.2d at 265. In addition, Bunker was given approval by the Martin Marietta Board of Directors to become a Sperry director at the time that the Martin Marietta Board was informed of its ten million dollar investment in Sperry. The court noted the inescapable inference to be drawn therefrom. Finally, the court noted that Martin Marietta had similar representatives on the boards of other corporations, albeit Bunker's position in the Martin Marietta hierarchy was atypical.

Hopefully, Feder can be distinguished from most other seemingly analogous situations because Bunker exercised a significant degree of control over the deputizing entity. The court itself noted the difference between Bunker's position vis-à-vis Martin Marietta and that of Thomas in Blau v. Lehman. Id. at 264-65. However, later in the opinion, the court dismissed the distinction between Bunker and other Martin Marietta representatives sitting on the boards of other companies, stating that Bunker's controlling position was of no import. Id. at 265. The utilization of this policy of Martin Marietta, i.e., the staffing of corporate boards with its representatives, as a factor in finding Bunker to be a deputy, is a bit circular. It also points up the "real world" problems posed by the Second Circuit's rationale. One significant question which remains unanswered is the possible liability arising from the designation to the issuer's board of an individual who is not in a controlling position with respect to the defendant.
existing SEC exemptive rules. However, the apparent simplicity of the statutory scheme has yielded to significant interpretative problems when applied to a variety of complex transactional areas probably not anticipated in 1934, including the modern forms of corporate reclassifications and reorganizations, stock option and employee stock purchase plans. In confronting these problems, the courts have developed an expanding body of law by which they have attempted to satisfy the statutory purpose while avoiding harsh and uneven results. This has culminated in the recent significant Supreme Court decision in Kern County Land Co. v. Occidental Petroleum Corp., which indicates that the jurisprudence of Section 16(b) has reached an interesting, albeit somewhat troubling, maturity.

In conventional cash purchases and sales of securities, the courts have implemented the statutory objective through a literal, automatic approach to the imposition of liability. In scrutinizing non-cash transactions, the matter is one of definition, i.e., whether a "purchase" or "sale" has occurred for Section 16(b) purposes which would trigger liability for short-swings profits. However, the definitions of "purchase" and "sale" in the Exchange Act furnish little assistance in identifying which non-cash transactions reflect the "unfair use of [inside]
information" which the statute seeks to prevent. Thus, the courts have reflected considerable doubt upon the wisdom of applying Section 16(b) in a rigid or automatic fashion and have increasingly resorted to a flexible or pragmatic approach for the purpose of determining whether liability should ensue where the transaction under scrutiny consists of a non-cash realignment or potential alteration of an insider's equity interest in the issuer. In applying this approach, before determining whether a "purchase" or "sale" has occurred for statutory purposes, the court will, in most cases, inquire into the question of whether the transactions under scrutiny and the statutory insider's relationship thereto present such a possible or potential opportunity for speculative abuse, as distinguished from its actual demonstration, as the statute is designed to curb.

In effect, this limited inquiry furnishes the means of rebutting the statutory presumption of unfair use of inside information whenever one or both of the transactions effected by a statutory insider within a six-month period is not a conventional cash purchase or sale.

The first cases to reflect the adoption of the speculative abuse approach to the statute involved transactions in convertible securities. In Ferraiolo v. Newman, the Sixth Circuit held in 1958 that the conversion of preferred shares into common shares of the same issuer did not constitute a "purchase" for Section 16(b) purposes and could not, therefore, be matched with a subsequent sale of the underlying common shares. The court noted that the insider had no control with respect to the issuer's decision to call the preferred shares for redemption which, in turn, led to a "forced" conversion. In addition, the convertible preferred shares and the underlying common shares were deemed by the court to be "economic equivalents" in terms of the market values ascribed to both classes of such securities, thereby pointing to the fact that the insider had not altered his investment position.

The rationale of Ferraiolo was quite different from the automatic approach adopted earlier by the Second Circuit in Park & Tilford, Inc. v. Schulte, where the court stressed the all-inclusive definition of "purchase" in the Exchange Act. The Ferraiolo decision also differed from the approach subsequently taken by the Third Circuit in 1965 in Heli-Coil Corp. v. Webster, where the court followed 12 The preamble of § 16(b) states that the statute was designed "for the purpose of preventing the unfair use of [inside] information ...." Id. at § 78p(b) (1970).


16 259 F.2d at 345-46.

17 Id.

18 Id.

19 352 F.2d 156 (3d Cir. 1965). The court, applying the automatic approach, determined that the conversion of convertible debentures into common shares constituted a "purchase"
Park & Tilford in finding liability, but held, upon the urging of the SEC,\(^2\) that no profit had been realized on the conversion constituting the “sale.”

The most comprehensive statement of the speculative abuse test was articulated in 1966 by the Second Circuit in *Blau v. Lamb*\(^2\) which, although arising in the area of convertible securities, has become a central precedent in other interpretative areas of Section 16(b) as well. In that case, the court held that the conversion of preferred shares into common shares, which occurred within six months of the “purchase” of the preferred shares, did not constitute a “sale” for purposes of the statute.\(^2\) Judge Waterman rejected an automatic construction of Section 16(b), preferring to determine whether the transaction in question could possibly lend itself to speculative abuse.\(^2\)

Having adopted this mode of analysis, the court found that there could be no such speculative abuse where the convertible preferred shares and the common shares were “economic equivalents.”\(^2\) However, Judge Waterman limited the concept of economic equivalence to the facts of the case—i.e., where the convertible security had an ascertainable market value which was at least equal to that of the underlying security. The decision was careful to note that such concept was inapplicable to the issuance of securities by one issuer in exchange for those of a second issuer.\(^2\)

Significantly, the *Lamb* case involved a cause of action arising prior to the promulgation by the SEC of Rule 16b-9, which provides that the acquisition or disposition of equity securities upon conversion of one class into another class of such securities of the same issuer is generally exempt from the operation of Section 16(b). The exemption provided by the rule is unavailable if there has been a combination of a “purchase” of the convertible security and a “sale” of the underlying security, or a “sale” of the convertible security and a “purchase” of the underlying security, within any six-month period including the date of conversion.\(^2\)

of the common shares to be matched with the subsequent sale of the common shares. The same act of converting the debentures into common shares was held to constitute a “sale” of the debentures which could be matched with their prior purchase.

21 The Commission also submitted an amicus brief in *Ferraiolo v. Newman*, 259 F.2d 342 (6th Cir. 1958), cert. denied, 359 U.S. 927 (1959). Exchange Act § 3(b) provides that the SEC has the “power by rules and regulations to define technical, trade and accounting terms . . .” 15 U.S.C. § 78c(b) (1970). Similarly, the Commission is specifically empowered to promulgate rules and regulations under § 16(b) in order to exempt any transaction “as not comprehended within the purpose of . . . [the] subsection.” Id. § 78p(b). With respect to rules promulgated by the Commission, the staff has issued interpretative letters. See, e.g., note 158 infra. However, as it has no enforcement powers under § 16(b), the Commission has consistently refused to render any interpretations concerning that provision. See, e.g., Robert S. Persky, 1971 Wash. Serv. Bur. Index (available July 23, 1971); see also SEC Rule 12h-3 (exemption from the operation of § 16(b) for transactions occurring prior to registration under § 12(g)). 17 C.F.R. § 240.12h-3 (1973).

22 363 F.2d 507 (2d Cir. 1966), cert. denied, 385 U.S. 1002 (1967).

23 363 F.2d at 522.

24 Id. at 517-19.

25 Id. at 521-23.

26 Id. at 523-25.

27 Rule 16b-9 provides as follows:

(a) 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; Provided, however, That this rule shall not apply to the extent that there shall have been either (1) a purchase of any equity security of the class convertible (including any acquisition of or change in a conversion privilege) and a sale of any equity security of the class issuable upon
Although Rule 16b-9 has largely removed uncertainties in transactions involving convertible securities, the development of the law with respect to other categories of extraordinary, non-cash transactions leaves certain important questions unanswered. Two such areas which are of considerable importance in today's corporate and financial world are (1) corporate reorganizations and (2) transactions in stock options issued pursuant to either stock option or employee stock purchase plans or granted or acquired in transactions frequently related to corporate reorganizations. This article focuses on a review of the factors which have been determinative in recent interpretations of Section 16(b) in these two areas. It seeks to examine whether the cases reveal any consistent body of law which may be relied upon by the bar in assessing the potential liability under Section 16(b) arising from a particular factual setting or series of transactions. An inquiry into these unresolved problems leads, in turn, to the question of whether judicially developed criteria for interpreting so highly technical a statute are adequate from the standpoint of predictability and fulfillment of statutory purpose.

II. Corporate Reorganizations and Speculative Abuse

Corporate reorganizations include mergers, consolidations, exchanges of securities by the shareholders of the acquired corporation for those of the acquiring corporation, or exchanges of assets of the acquired corporation for securities of the acquiring corporation. Reorganization transactions may also result from tender offers for cash or securities if the management of the target company is hostile to the tender offeror and arranges a "defensive merger" with another corporation. Accordingly, corporate reorganizations may either reflect the mutual desire of the parties to combine the assets and operations of different
entities or may represent the final episode in a contested bid for corporate control. While it is clear that an exchange of securities of one corporation for those of another corporation does not, in and of itself, constitute a matchable “purchase” and “sale” of securities which would invoke liability under Section 16(b), nevertheless these exchanges of securities, when matched with other transactions in the same class of securities of either issuer prior or subsequent to the reorganization, raise difficult questions of potential liability under the statute.

The signal event in the history of the interpretation of Section 16(b) in the context of corporate reorganizations is the Supreme Court’s 1973 decision in *Kern County Land Co. v. Occidental Petroleum Corp.*, 33 which arose out of a cash tender offer by Occidental in 1967 to purchase shares of Kern County Land Company. Pursuant to this offer, Occidental ultimately acquired approximately 22% of the outstanding shares of Kern and had become a more-than-10% shareholder of Kern by May 1967. Kern’s management, which had previously rejected Occidental’s proposals for a merger, reacted to the tender offer by arranging for the sale of Kern’s assets to a newly formed subsidiary of Tenneco, Inc. in exchange for a new class of preferred shares of Tenneco. Confronted with this prospect of a defensive merger, Occidental and Tenneco entered into an agreement in early June 1967 whereby Occidental granted Tenneco an option to purchase at a fixed price all of the Tenneco preferred shares to be issued to Occidental, as a shareholder of Kern, pursuant to the reorganization. This option was conditioned upon consummation of the Kern-Tenneco reorganization and was exercisable upon the expiration of six months following the date of its grant. Occidental subsequently abstained from voting its Kern shares with respect to, and also indicated its non-opposition to, the proposed reorganization with Tenneco. After some abortive attempts by Occidental to delay its consummation, the Kern-Tenneco reorganization was completed in late August 1967, less than six months after the date upon which Occidental, through its cash tender offer purchases, had become a statutory insider. The option granted by Occidental to Tenneco was exercised by a designee of Tenneco in December 1967, slightly more than six months after the date of grant. The plaintiff contended that the transfer of Kern shares upon the Kern-Tenneco reorganization and the grant by Occidental of the option to purchase Tenneco shares both constituted “sales” within the meaning of Section 16(b) which could be matched with Occidental’s purchase of the Kern shares within six months prior thereto.

The Second Circuit reversed the decision of the district court and granted summary judgment in favor of Occidental. 34 The court held that Occidental was not liable for any “profits” it derived upon the exchange of Kern shares for the Tenneco preferred shares incidental to the reorganization 35 and that the Occidental-Tenneco option did not constitute a “sale” for purposes of Section 16(b). 36 Applying the speculative abuse test, Judge Friendly stressed the fact that, by

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32 Cf. *Heli-Coil v. Webster*, 352 F.2d 156 (3d Cir. 1965), discussed at note 20 supra.
33 *411 U.S. 582 (1973).*
35 *450 F.2d at 165.*
36 *Id.*
reason of the antagonistic posture of Kern's management, Occidental did not have access to inside information and did not control the timing or terms of the Kern-Tenneco reorganization. The Supreme Court, affirming the Second Circuit, squarely held that, despite the fact that Occidental was a statutory insider, its inability to control Kern or the course of the Kern-Tenneco defensive merger and the related failure to demonstrate that Occidental had access to inside information required a finding of no liability under Section 16(b).

The Kern case represents the first occasion upon which the Supreme Court addressed itself directly to the question of Section 16(b) liability arising out of a non-cash securities transaction incident to a corporate reorganization. In Kern the Court put its imprimatur on the validity of the speculative abuse test by noting that the crucial question in extraordinary transactions is whether the transaction may serve as a vehicle for the evil which Congress sought to prevent—the realization of short-swing profits based upon access to inside information—thereby endeavoring to implement congressional objectives without extending the reach of the statute beyond its intended limits.

In sanctioning the use of the speculative abuse test to determine whether the acquisition or disposition of securities incident to a corporate reorganization will be deemed a "purchase" or "sale" for Section 16(b) purposes, Kern did not stress the broad definitions of those terms under the Exchange Act. Rather, the Kern analysis of the terms "purchase" and "sale" was undertaken with reference to whether the circumstances of the transactions under review mandated the imposition of liability in light of statutory purpose. The Court acknowledged the statutory presumption that Occidental, by virtue of its position as an insider, possessed the potential for speculative abuse which the statute was designed to curb, but regarded as determinative the realities of Occidental's position vis-à-vis the hostile management of Kern. It found that the possibility that Occidental could gain access to inside information was quite remote since Occidental's efforts were opposed by the management of Kern throughout the relevant period. With respect to the issue of control, the Court noted that the Kern-Tenneco merger was "not engineered by Occidental" and that Occidental neither participated in, nor controlled, the negotiations. It thus appears that the Kern opinion focused on two variables in order to determine whether the statutory presumption should be rebutted: (1) access to inside information and (2) the insider's control relationship to the issuer with respect to transactions under scrutiny.

37 Id. at 163.
38 411 U.S. at 598-600. The analysis of the application of § 16(b) with respect to option transactions begins at text accompanying note 113 infra.
39 411 U.S. at 594-95.
40 Id. at 593-95.
41 Id. at 598-600.
42 Id. at 598.
43 Id. at 599.
44 Id.
A. The Control Variable

The Supreme Court's *Kern* opinion seems to indicate that "control" is relevant under Section 16(b) only if an insider has the power to engage in unfair short-term trading by reason of his relationship to the issuer and to the series of transactions under review. The Court's concept of control thus appears to be more limited and to serve a more special purpose than the broad concepts of control appearing throughout the various federal securities statutes. While the Supreme Court determined that the facts of *Kern* pointed to the conclusion that Occidental controlled neither Kern nor the course of the Kern-Tenneco defensive merger, there have been reorganization transactions where the test enunciated by the *Kern* Court would probably have resulted in liability. In this respect, the Second Circuit's 1970 decision in *Newmark v. RKO General, Inc.* is instructive. *Newmark* arose out of a merger in 1967 between Frontier Airlines, theretofore controlled by RKO, and Central Airlines. In the course of negotiating the merger, RKO obtained an option to purchase securities representing approximately 49% of the outstanding shares of Central at a fixed price upon the fulfillment of certain conditions precedent to the merger. RKO and the Central shareholders agreed to vote their respective controlling interests in favor of the merger. RKO had no fixed obligation to consummate the purchase, as it retained the express privilege to abandon both the merger and purchase agreements if, in its own "good faith judgment," the Civil Aeronautics Board subsidy was inadequate. The terms of these transactions were agreed upon prior to public announcement of the impending merger, which predictably resulted in an appreciation in the market price. Upon satisfaction of the conditions, RKO exercised its option to purchase the controlling block of the Central securities, and the Frontier-Central merger was consummated shortly thereafter. The Second Circuit, impressed with the control which RKO possessed and the unfair trading advantage which it had secured as a result of such control, found the presence of a potential for speculative abuse and characterized RKO's position as "[h]eads I win, tails I do not lose."

45 Id. at 599-600.
46 The definition of "control" as promulgated by the SEC under Rule 405 of the Securities Act of 1933 is as follows:

The term "control" (including the terms "controlling," "controlled by" and "under common control with") means the possession, direct or indirect, of the power to direct or cause the direction of the management and policies of a person, whether through the ownership of voting securities, by contract, or otherwise. 17 C.F.R. § 230.405(f) (1973). See also Investment Company Act of 1940 § 2(a)(9), 15 U.S.C. § 80a-2(a)(9) (1970) ("[c]ontrol means the power to exercise a controlling influence over the management or policies of a company, unless such power is solely the result of an official position with such company").
48 The purchase contract required the sellers, the owners of 66% of Central's voting shares, to cause Central to take all necessary corporate action to authorize and approve the merger with Frontier; similarly, RKO, the owner of 56% of Frontier's voting shares, was required to cause Frontier to take all necessary corporate action to authorize and approve the merger with Central. 425 F.2d at 351-52 n.3.
49 Id. at 353.
50 Id. at 354. In *Newmark*, the basic award of damages was the difference between the price which RKO paid for its Central securities and the market value, on the date of the merger, of the Frontier securities which RKO received in return for its holdings in Central. Id. at 357. For a discussion of the "control premium" see infra. The Central securities were
With respect to the question of control, *Newmark* is distinguishable from, and thus remains an important precedent even after, the Supreme Court's holding in *Kern*, in which the element of control of the issuer and the reorganization process were also central considerations. In *Newmark*, which involved a non-contested transaction, the presence of that control or power was demonstrated and the statutory presumption could not be rebutted. In contrast, *Kern*, which involved a contested bid for control during the crucial statutory period, held that such power was lacking.

deemed to include not only the Central common shares which RKO actually held, but the Central common shares into which the Central debentures were convertible. The computation of damages, therefore, included the difference between the cost to RKO of the debentures and the value of the Frontier shares for which approximately 150,000 Central shares (the number of shares into which the debentures were convertible) were exchangeable pursuant to the merger. In reaching this conclusion, the court looked to RKO's purpose in purchasing the debentures and the manner in which the parties themselves characterized these securities in the merger agreement. The court decided that RKO purchased the debentures because of their convertibility into Central common. Accordingly, the cost of the debentures was based not upon the face value of the debentures, but rather upon the number of Central shares into which they could be converted and the purchase price of each such share. *Id.*

In *Kramer v. Ayer*, 317 F. Supp. 254 (S.D.N.Y. 1970), the court was faced with the problem of calculating the defendant's cost. The profit realized upon the proscribed sales was held to be the difference between the net receipts derived from such sales less the cost of the shares sold. *Id.* at 257. The cost was equal to the value of that which was given up in order to obtain that which was sold. *Id.* at 257-58. The court indicated a marked preference toward using the lowest market price on the appropriate date, where available, rather than the bid and asked quotations, particularly since the shares were actively traded. *Id.* at 258-60. The justification for using the lowest market price was the rationale of *Smolowe v. Delendo Corp.*, 136 F.2d 231 (2d Cir.), *cert. denied*, 320 U.S. 751 (1943), which provides that the recoverable profit under § 16(b) shall be the difference between the highest sales price and the lowest purchase price.

In *Mueller v. Korholz*, 449 F.2d 82 (7th Cir. 1971), *cert. denied*, 405 U.S. 922 (1972), the basic premise was the same—from the amount received by the defendant was subtracted the cost of the Gypsum shares which he had sold. *Id.* at 86. The cost was the market value so far as it could be ascertained as of the appropriate date. *Id.* at 86-88. On the appropriate date, however, there was no actual trading in Gypsum shares. The court, therefore, utilized the bid and asked quotations to ascertain the market value. *Id.* at 87. It refused to use the low bid price and stated that *Smolowe is merely a guide to be used when two reasonable alternatives are present. "[Smolowe] does not require a court to adopt a completely unrealistic interpretation of the market." Id; see Allis-Chalmers Mfg. Co. v. Gulf & West. Indus., Inc., CCH CURRENT FED. SEC. L. REP. ¶ 94,421, at 95,430 (N.D. Ill. Jan. 30, 1974).

The courts have begun to take into account in the computation of § 16(b) damages the concept of a "control premium." Thus in *Newmark*, the court found that the block of Frontier shares which were exchanged for the block of Central shares had a special value to RKO since RKO could not have retained legal control of Frontier following the merger without it. It thereupon increased the value of the Frontier shares which RKO had "sold" by 15%. 425 F.2d at 357-58. The actual percentage was based upon past sales of large blocks of Frontier shares.

In *Korholz*, the "premium" doctrine was utilized to reduce the § 16(b) damages. As consideration for the shares purchased, Korholz parted with a controlling block of Gypsum shares. By means of expert testimony at trial, the premium was valued at 20%. 449 F.2d at 88. Thus, the cost of that with which Korholz had parted was increased, resulting in a determination that he realized no profit under § 16(b).

A number of courts have also dealt with the question of dividends as part of the recoverable profit under § 16(b). In *Adler v. Klawans*, 267 F.2d 840 (2d Cir. 1959), cash dividends were declared after defendant had become a director and during the period between the prescribed purchase and sale. The court found that the "shares on which the . . . dividends were declared and paid . . . were sold . . . at a loss . . . which was greater than the amount of the dividends." *Id.* at 849. Thus, no profits were realized by the insider.

In *Western Auto Supply Co. v. Gamble-Skogmo*, Inc., 348 F.2d 736 (8th Cir. 1965), *cert. denied*, 382 U.S. 987 (1966), a case involving cash dividends received by an insider between the date of his acquisition of the issuer's securities and his subsequent disposition thereof, the dividends were included in the profit realized which was recoverable by the issuer. The court distinguished the situation at bar from that discussed in *Klawans*, noting that the defendant in *Gamble-Skogmo* was an insider at the time of the declaration and payment of the
The *Kern* opinion also dealt with the question of the scope of the concept of control from the standpoint of speculative abuse under the statute. This question had been somewhat obfuscated by a 1971 district court decision in *American Standard, Inc. v. Crane Co.*\(^5\) which was decided subsequent to the Second Circuit's decision in *Newmark* and the district court's decision holding Occidental liable in the *Kern* case. *Crane* involved a cash tender offer by Crane for shares of Westinghouse Air Brake in June 1967. After a proposal for a Crane-Air Brake merger was rejected by the management of Air Brake, Crane resumed the purchase of additional Air Brake shares, thereby becoming a statutory insider in early 1968. This provoked an agreement for a defensive merger by Air Brake with American Standard. After public disclosure of the proposed merger, the management of Crane, recognizing the problems inherent in its becoming a minority shareholder of American Standard, undertook a further tender offer for additional Air Brake shares pursuant to which it ultimately became the holder of approximately 32% of the outstanding shares of Air Brake. In the course of the dividend. *See Marquette Cement Mfg. Co. v. Andreas*, 239 F. Supp. 962 (S.D.N.Y. 1965), where cash dividends, declared and issued after the defendant had become an insider and during the interval between purchase and sale, were viewed as additional profit realized. "The 'possibility' of insider manipulation of the dividend, noticeably absent in the *Adler* case, is surely present here." *Id.* at 968.

In *Abrams v. Occidental Petroleum Corp.*, 323 F. Supp. 582 (S.D.N.Y. 1971), *rev'd on other grounds*, 450 F.2d 157 (2d Cir. 1971), *aff'd sub nom.* Kern County Land Co. v. Occidental Petroleum Corp., 411 U.S. 582 (1973), the court held that the recoverable profit included (1) the third quarter dividend on the Kern shares which was paid on September 21, 1968 and (2) the initial quarterly dividend on the Tenneco preference shares which was paid on January 9, 1968:

> Both dividends ... were expressly contracted for in the June 2 option agreement ... The dividend on the ... Kern stock is clearly recoverable under the views expressed in *[Klawans]* and its progeny. *Citing Marquette Cement & Gamble-Skogmo.*

> ... The dividend on the Tenneco Preference Stock was provided for in Tenneco's Certificate of Incorporation and not subject to the kind of insider manipulation cited in *Adler* ... However, where such a dividend is expressly contracted for regardless of the record ownership of the stock ... other opportunities for abuse are present. 323 F. Supp. at 582-83. One opportunity for speculative abuse arises "where parties contract for a low sales price (resulting in a small capital gain) with the retention of future dividends by the seller." *Id.* at 583.

In *Falco v. Donner Foundation, Inc.* [1952-1956 Transfer Binder] COCH Fed. Sec. L. REP. ¶ 90,612 (S.D.N.Y.), *rev'd on other grounds*, 208 F.2d 600 (2d Cir. 1953), an insider had made a sale followed by a purchase of the issuer's securities. Dividends were declared and paid by the issuer during the interval. The court deducted these dividends from the "gross" profit realized.

*But see Blau v. Lamb*, 242 F. Supp. 151 (S.D.N.Y. 1965), *aff'd*, 363 F.2d 507 (2d Cir. 1966), *cert. denied*, 385 U.S. 1002 (1967), where, in the context of a non-cash transaction, a cash dividend was deemed "too incidental and not 'so inextricably connected' with defendant's purchase-and-sale transactions as to be included in the amount recoverable." 242 F. Supp. at 161. In reaching this conclusion, the court emphasized the issuer's history of paying quarterly cash dividends for a period of at least one year prior to the dividend in question. Interestingly, the Second Circuit differed with the district court and required a proportionate adjustment in the price per share for the purpose of computing the recoverable profit where a sale of securities, occurring prior to a 100% stock dividend, was matched with a subsequent purchase of securities occurring after such stock dividend. 363 F.2d at 527. For an analysis of the question of damages in the context of speculative abuse under the statute see *Lang & Katz, Liability for "Short Swing" Trading in Corporate Reorganizations*, 20 Sw. L.J. 472 (1966).

The *Proposed Federal Securities Code* of the American Law Institute provides that liability under § 1413, the analogue of § 16(b), is to be reduced by the costs, interest and damages (not including attorneys' fees) incurred by the defendant in connection with suits arising under other "insider trading" liability provisions. *ALI Fed. Sec. Code* § 1413(1) (Tent. Draft No. 2, 1975). This section of the *Code* is discussed in more detail at note 191 infra.

battle for corporate control, American Standard engaged in certain purchases and sales of Westinghouse shares subsequently found by the Second Circuit to constitute violations of the anti-manipulative provisions of Sections 9 and 10(b) of the Exchange Act. In June 1968, soon after consummation of the defensive merger between Air Brake and American Standard, Crane sold, at a considerable profit, substantially all of the American Standard shares issued to it upon the merger. These sales occurred within six months of the date upon which Crane had become the holder of more than 10% of Air Brake's shares.

The district court held that, notwithstanding Crane's allegations that it was a "forced seller," Crane's exchange of Air Brake shares pursuant to the defensive merger constituted a "sale" for Section 16(b) purposes to be matched with its prior purchases of Air Brake shares within the statutory period. In support of its conclusion, the district court found that "opportunities for speculative abuse did inhere in Crane's transactions" since Crane, aware of the possibility of reaping a substantial profit arising from the dynamics of the contest for corporate control, continued to purchase Air Brake shares even after the rejection of its original merger proposal. The court analogized Crane's position to that of RKO in Newmark. It also advanced the related proposition that since Crane was in a position to influence the course and terms of the Air Brake-American Standard merger in "significant ways" by establishing the terms of its own tender offer, it was liable under Section 16(b).

Crane articulated a concept of control which could be ascribed to a statutory insider although that insider did not occupy the type of relationship with the issuer which would permit it to be a significant moving force in the transactions under scrutiny—indeed, where the insider was confronted by the hostile management of the issuer. The Supreme Court in Kern seems to have undercut Crane's concept of control by holding that the potential for the realization of a substantial profit by Occidental, whose antagonistic relationship to the management of the target company paralleled that of Crane, was irrelevant to the question of speculative abuse in the absence of access to inside information. Without citing Crane, the Court stated:

"It is also wide of the mark to assert that Occidental, as a sophisticated corporation knowledgeable in matters of corporate affairs and finance, knew that its tender offer would either succeed or would be met with a "defensive merger." If its takeover efforts failed, it is argued, Occidental knew it could sell its stock to the target company's merger partner at a substantial profit. Calculations of this sort, however, whether speculative or not and whether fair or unfair to other stockholders or to Old Kern, do not represent the kind of speculative abuse at which the statute is aimed, for they could not have been based on inside information obtained from"

53 346 F. Supp. at 1161.
54 Id. at 1159.
55 Id. at 1161.
56 Id. at 1160-61.
57 Id. at 1161. See the Supplemental Opinion of the district court which was occasioned by the Second Circuit's holding in the Kern case and which stressed considerations discussed at the text accompanying notes 83-94 infra. 346 F. Supp. 1165 (S.D.N.Y. 1972).
substantial stockholdings that did not yet exist. Accepting both that Occidental made this very prediction and that it would recurrently be an accurate forecast in tender-offer situations, we nevertheless fail to perceive how the fruition of such anticipated events would require, or in any way depend upon, the receipt and use of inside information. If there are evils to be redressed by way of deterring those who would make tender offers, § 16(b) does not appear to us to have been designed for this task.58

Thus, Justice White indicated in Kern that the ability of an insider to derive a profit from a series of transactions, one of which is extraordinary in nature, is not a concomitant of the control aspect of the speculative abuse test where access to inside information is not a factor in yielding that profit.59

Significantly, the Kern Court also delineated the relationship between the control variable and the concept of access to inside information. As the Court's analysis indicates, control denotes and, in effect, assumes access to inside information, whereas such access can be ascribed to the insider even if he does not possess a control relationship to the issuer and to the transactions under scrutiny.60

That access to inside information can exist independent of the element of control appears to comport with the language and purposes of the statute.61

58 411 U.S. at 597-98 (emphasis supplied).
59 The Second Circuit appears to have invited Crane to appeal the district court's holding that Crane effected a "sale" of its Air Brake shares. BNA Sec. Reg. & L. Rep. No. 233, at E-1 (2d Cir. 1973). It stated that such appeal would serve to extricate the combatants from the "Brobdingnagian procedural imbroglio" that has characterized this litigation. Id.

Four days after the Standard-Air Brake merger, an Air Brake shareholder sued Air Brake, Standard and Crane under § 16(b). The complaint, filed prior to Crane's cash sales of the shares it received pursuant to the merger, alleged that Crane's demand of an appraisal of its Air Brake shareholdings, prior to consummation of the merger, constituted a § 16(b) "sale" of its Air Brake shares.

A second Air Brake shareholder sued shortly thereafter, alleging that Crane had violated § 16(b) by (1) purchasing Air Brake shares and then exchanging them for Standard shares pursuant to the reorganization and (2) selling the Standard shares within six months of receiving them in the merger exchange.

Subsequently, a Standard shareholder sued Crane derivatively, alleging that Crane's sale of Standard shares within six months of its purchase of Air Brake shares violated § 16(b).

Finally, Standard instituted its own § 16(b) action, alleging that Crane was liable for the short-swing profits it made on the entire sequence of transactions.

Crane thereupon filed a third-party complaint, an answer in the Standard suit and a motion to consolidate three of the § 16(b) actions pending against it. The third-party complaint, brought against the Air Brake directors, alleged that they had conspired to expose Crane to possible § 16(b) liability. The third-party complaint prayed for judgment against the Air Brake directors for any § 16(b) liability that Crane might suffer. Crane's answer to the Standard suit claimed that the merger exchange was neither a "purchase" nor a "sale," and that its cash sales of Standard shares, under threat of antitrust action, was not a § 16(b) "sale."

Judge McLean dismissed the Standard shareholder's suit and directed consolidation of the three other § 16(b) suits. An amended complaint was served by Standard on behalf of all three plaintiffs. Crane's answer included a defense and a counterclaim based upon alleged violations by Standard of §§ 9 and 10 of the Exchange Act. Standard replied that this counterclaim was barred by a previous judgment, the appeal of which was then pending. Crane proceeded to file another third-party complaint against the former Air Brake directors in late 1969, again seeking indemnity for the potential § 16(b) liability. These defendants answered that this claim was similarly barred. For the ultimate disposition on the question of liability in the fraud action see Crane v. Westinghouse Air Brake Co., 419 F.2d 787 (2d Cir. 1969), cert. denied, 400 U.S. 822 (1970).

In response to motions by both Crane and Standard for summary judgment with respect to the § 16(b) claim, Judge Lasker issued the Crane opinions analyzed at text accompanying notes 51 to 57 supra and text accompanying note 84 infra.

60 411 U.S. at 598-600.
61 See note 12 supra.
B. Access to Inside Information

The problems involved in analyzing the question of access to inside information in the context of extraordinary, non-cash transactions are illustrated by the Fourth Circuit's opinion in *Gold v. Sloan*, which was rendered shortly after the Supreme Court's decision in *Kern*. The *Gold* case was an outgrowth of the 1967 merger of Atlantic Research Corporation (ARC) into Susquehanna Corporation. Pursuant to the merger, Susquehanna issued newly created preferred shares for shares of ARC common. As a result of the merger, four ARC insiders became statutory insiders of Susquehanna. Within six months after the merger, each of these insiders sold Susquehanna shares in cash transactions. The Fourth Circuit applied the speculative abuse test to the varying relationships of the several statutory insider-defendants to ARC and to the ARC-Susquehanna merger, thereby making a painstaking analysis of whether each of the defendants could have had access to inside information concerning the surviving company during the pre-merger period. Based upon such analysis, it held that only ARC's chief executive officer, who had access to confidential information concerning Susquehanna not then available to other directors or shareholders of ARC, was liable under Section 16(b) for his post-merger sales of Susquehanna shares.

The court's analysis of the relationships of each of the insiders was undertaken for the purpose of ascertaining whether the statutory presumption could be rebutted. However, offering an unconvincing comparison to *Kern*’s emphasis upon the relationships of the parties during the period preceding the Kern-Tenneco merger, the majority in *Gold* saw fit to analyze the possibility of speculative abuse solely in terms of the knowledge and relationships of the defendants prior to their becoming statutory insiders of Susquehanna in order to determine whether a statutory “purchase” of Susquehanna shares occurred upon the merger. At no point in the majority's opinion was consideration given to the question of the presumptive access of any of the defendants to inside information following the date of the ARC-Susquehanna reorganization, despite the fact that the defendants became statutory insiders of Susquehanna only upon, or shortly after, its consummation. As Judge Winter correctly observed in his dissenting opinion, by focusing on pre-merger relationships only, the majority in *Gold* ignored the post-merger period when the defendants' status as Susquehanna insiders invoked the statutory presumption. It was that post-merger period which the dissent characterized as the proper period for scrutiny under the test.

It is arguable that the opinions of the *Gold* majority and dissent are both incorrect in asserting that only the period preceding or the period following the

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63 Id. at 94,794-801.
64 Id.
65 Id.
66 Id.
67 The court in *Morales v. Arlen Realty & Dev. Corp.*, 352 F. Supp. 941 (S.D.N.Y. 1973), was also confronted with a "merger-purchase" question. Similarly, it restricted its analysis to the possibility of speculative abuse during the pre-merger period. Id. at 944-45.
merger should be examined under the test. Indeed, Judge Winter’s dissenting opinion, after stating categorically that the period “following the acquisition” constitutes the “relevant inquiry,” proceeds to examine the relationships of the insiders to ARC and the reorganization process during the period preceding the merger as well. Presumably, if the test is designed to implement the statutory purpose, an examination of the question of access to inside information and its potential abuse should not be cut off automatically at the point of time where the defendant becomes, or ceases to be, a statutory insider of the specific issuer whose securities are traded.

A reading of Kern and Gold fails to clarify the application of the speculative abuse test where a non-insider of the acquired corporation becomes an insider of the acquiring corporation upon the merger and sells shares of the acquiring corporation, obtained as a result of the merger, within six months thereafter. In determining whether the reorganization constitutes a Section 16(b) “purchase,” it seems appropriate to acknowledge the statutory presumption of access to inside information as a result of insider status during the post-merger period.

The dissent in Gold was faced with the additional problem of an individual whose status as an insider of the acquiring corporation was achieved subsequent to the reorganization. Judge Winter determined that “this alone would [not] warrant applying § 16(b) . . . because there appears to be no connection, temporal or factual, between the merger transaction and his becoming an officer.” However, there would appear to be merit in an analogy to the cases where the courts, while not speaking the language of speculative abuse, have held directors or officers liable for their short-swing cash sales of securities purchased prior to their election to such offices. Similarly, the resignation of an officer or director during this post-merger period should not dissipate the taint of Section 16(b) where that insider sells securities obtained upon the merger within six months of the reorganization but subsequent to his resignation.

There is also some doubt respecting the appropriate result to be reached where an insider of the acquired corporation becomes an insider of the acquiring corporation upon the merger, sells shares of the acquiring corporation within six months of the merger and can rebut the statutory presumption only with respect to his activities during the post-merger period. Looking to the pre-merger period raises the possibility of imposing liability for “purchases” and sales of shares of the acquiring corporation as a result of the insider’s relationship to the acquired

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68 Id. at 94,804.
69 Id. at 94,804-07.
70 Id. at 94,806.

Where a non-insider purchases shares of the issuer sufficient to render him a more than 10% shareholder, that purchase constitutes the point in time at which the six-month holding period of § 16(b) commences. Stella v. Graham-Paige Motors Corp., 232 F.2d 299 (2d Cir.), cert. denied, 352 U.S. 831 (1956). This is so despite the statutory caveat which states that § 16(b) “shall not be construed to cover any transaction where [the more than 10% shareholder] was not such both at the time of the purchase and sale, or the sale and purchase . . . .” See generally Reliance Electric Co. v. Emerson Electric Co., 404 U.S. 418 (1972), discussed at text accompanying notes 95 to 106 infra.
corporation. Although the dissenting opinion in Gold appears to conclude that Section 16(b) has not been violated in such a case,73 that approach may create temporal distinctions which are as artificial as those set forth in the majority opinion. Kern is of little aid in this respect, since the Court dealt with a potential "sale," leaving unanswered the question of the effect to be given the pre-merger period when the inquiry concerns a potential "purchase."

C. Other Applicable Criteria for Speculative Abuse

It would appear from the preceding discussion of Kern, and its significance in light of the other reorganization cases applying the speculative abuse test, that the test, as thus far enunciated by the courts, entails an examination of the two interrelated variables of access to inside information and ability to control the decision to effect a reorganization or its terms and timing. Under the current state of the law, Section 16(b) liability may be imposed even if an insider can demonstrate either that there has been equality of treatment upon the reorganization, in the sense that the insider has retained the same equity interest proportionate to that of the other holders of the same class of securities of the issuer, or that he has not effected a realization by converting his investment to cash or non-equity securities which are cash equivalents. Even where these factors are present, the precedents indicate that an insider will be held liable under Section 16(b) if he is unable to rebut the statutory presumption that he has, by reason of his status as an insider, either access to inside information or an ability to control or materially influence the course of the reorganization.74

However, not all of the courts have completely ignored an inquiry into the consequences of the non-cash transaction in order to determine the existence of the potential for speculative abuse. Several decisions, both within and without the corporate reorganization context, reflect the concern for the effects of the extraordinary transaction from the standpoint of whether the insider has derived any advantages not shared by other holders of the same class of securities of the issuer. In Roberts v. Eaton,75 which preceded the articulation of the speculative abuse test in Lamb and which involved a reclassification of the securities of an issuer after its approval by shareholders, the Second Circuit held that the issuance of securities pursuant to the reclassification did not constitute a "purchase" within the meaning of Section 16(b) to be matched with the private sale of such

73 Although this particular factual setting was not presented in Gold, an examination of the analysis with respect to the defendant, Scurlock, would seem apposite. The majority, reversing the district court, found that Scurlock did not possess the potential for speculative abuse during the pre-merger period. [1973 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 94,186, at 94,799 (4th Cir. 1973). The dissent determined that Scurlock was unable to rebut the statutory presumption during the post-merger period and, therefore, argued for affirmance. Id. at 94,805.


75 212 F.2d 82 (2d Cir.), cert. denied, 348 U.S. 827 (1954).
Emphasizing the like treatment of all shareholders and the retention by insiders of the same proportionate equity interests in the issuer, the court specifically found that the reclassification could not possibly lend itself to the type of speculative abuse which Section 16(b) was designed to prevent. Furthermore, *Newmark* and, to some extent, *Gold* appear to recognize the need to weigh the consequences of the extraordinary transaction from the standpoint of the relative treatment of all shareholders. The decision in *Newmark* reflects a concern for the special benefit which RKO, as a controlling shareholder of Frontier, derived from its option to purchase the controlling block of Central shares at a fixed price. Nevertheless, the *Newmark* court's emphasis upon RKO's negotiation of the merger and obtaining of the option prior to its public disclosure ignores the fact that RKO would have obtained an unfair benefit or special advantage by reason of its controlling position even had that option been granted after public announcement of the impending Frontier-Central merger.

Directly related to the question of the derivation by the insider of any special benefits is the issue of whether the insider receiving equity securities of another issuer upon a corporate reorganization realizes a profit by reason of the reorganization. Realization in an economic sense seems to occur where an insider receives cash or debt securities upon the reorganization. It appears that the lack of realization should be taken into account in determining whether a particular reorganization or other non-cash transaction yields the possibility of speculative abuse.

**D. Reorganizations Intervening Between Cash Transactions: The Concept of "Issuer"**

A review of *Newmark, Crane, Kern* and *Gold* points to the further question of whether Section 16(b) liability will be triggered if, within a six-month period, the insider has effected a cash purchase and a cash sale of the securities of the two issuers involved in the intervening reorganization. In *Crane*, the district court was confronted with purchases of Air Brake securities (whereby Crane became a statutory insider), the intervening Air Brake-American Standard merger, and Crane's cash sales of American Standard securities, all of which occurred within a six-month period. Recognizing that the Second Circuit's decision in *Kern* cast doubt upon its prior finding that Crane had effected a "sale" of the Air Brake shares upon the merger with American Standard, the *Crane* court reconsidered its decision and determined that Section 16(b) liability should still be imposed because Crane had effected a cash purchase of Air Brake shares.

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76 212 F.2d at 85-86.
77 Id. at 83-85.
78 425 F.2d at 353-54.
80 425 F.2d at 353-54.
81 Id. at 353.
82 See generally Mueller v. Korholz, 449 F.2d 82 (7th Cir. 1971), cert. denied, 405 U.S. 922 (1972), where the court rejected, in dictum, the plaintiff's contention of § 16(b) liability as "[the defendant] gained nothing but the benefits of the merger itself." 449 F.2d at 86.
within six months of its subsequent cash sales of American Standard shares. The Crane court thus appears implicitly to have held that such cash purchases and sales within the statutory six-month period may be matched despite the fact that the transactions involved the securities of two different issuers.

The Supreme Court in Kern did not have to address this question because more than six months elapsed from the date that Occidental became a statutory insider of Kern until the date of its subsequent cash sale of the Tenneco shares upon exercise of the option. In this respect, the Court, in viewing the Occidental-Tenneco option, was careful to note that it was not exercisable until the expiration of the six-month period, "a period that, under the statute itself, is assumed to dissipate whatever trading advantage that might be imputed to a major stockholder with inside information." The fact that the Court, had it found the potential for speculative abuse, might well have matched Occidental's cash purchase of Kern shares with its subsequent grant of an option with respect to Tenneco shares within the statutory period could be interpreted as support for the theory that transactions in the securities of two different issuers may be matched under certain circumstances. However, the Court's statement that it did not find "a sufficient possibility for the speculative abuse of inside information with respect to Old Kern's affairs to warrant a holding that the option agreement was itself a 'sale'" could indicate that the Court treated the option as relating to shares of Kern rather than to the Tenneco shares later acquired by Occidental upon the merger. This treatment may be justified because the merger had not yet been consummated and because the Tenneco shares had not been issued as of the date of grant of the option. If the Court so regarded the option, the "two issuer" problem was not presented; and the Kern decision would not support the rationale of the Supplemental Opinion in Crane. In view of the fact that Crane may still have some precedential value in this area, counsel would be well advised to recommend to statutory insider clients that they defer their cash sales until more than six months have expired since their cash purchases, despite the intervening non-cash, extraordinary transaction occasioned by the reorganization.

The type of analysis utilized in Crane, which is implicit in matching transactions in the securities of two different issuers, reflects a blurring of the "issuer" concept when dealing with corporate reorganizations. Since Section 16(b) speaks in terms of purchases and sales of the securities of a single "issuer," this type of analysis may be inappropriate where an intervening corporate reorganization results in the acquisition or transfer by an insider of securities of an entity

84 Id. at 1167-68.
85 Occidental had become a statutory insider by May 10, 1967. 411 U.S. at 585. The option, granted by Occidental on June 2, 1967, was exercised on December 11, 1967. Id. at 589.
86 Id. at 603.
87 Id. at 601. See text accompanying note 130 infra.
88 The Court could have analyzed the transaction in a manner similar to that employed by the Seventh Circuit in Bershad v. McDonough, 428 F.2d 693 (7th Cir. 1970), cert. denied, 400 U.S. 992 (1971), in order to find that a "sale" of Kern shares had occurred despite the granting of a call option on the Tenneco preferred shares. Such a finding would have been more easily reached if, for example, Occidental had granted to Tenneco the right to vote Occidental's Kern shares. For a detailed analysis of Bershad see text beginning at note 126 infra.
89 Section 16(b) speaks in terms of an equity security "of such issuer . . ." 15 U.S.C. § 78p(b) (1970) (emphasis supplied).
distinct from the predecessor in which the insider originally purchased securities. From the standpoint of assets, business or history of operations, there is little justification for equating Air Brake with American Standard or for equating any of the predecessor corporations with its successor in the other cases.

However, Crane does not represent the first instance arising under Section 16(b) in which courts have construed the term “issuer” to denote both the successor and the predecessor corporation. In Blau v. Oppenheim, a district court in 1966 was confronted with the question of whether a holder of the shares of the surviving corporation could institute an action under Section 16(b), without complying with the contemporaneous ownership requirement applicable to derivative actions, where the predecessor corporation transferred all of its assets, including its causes of action, to the corporate successor. The court answered this question affirmatively. A negative answer under the facts of Oppenheim would have effectively precluded the only potential plaintiffs from bringing the action, thereby insulating the defendant from liability for his short-swing profits. Nevertheless, since the assumption that both the acquired and acquiring corporations constitute the same “issuer” is inconsistent with the language of Section 16(b), it would appear that Oppenheim should be construed as relating solely to the issue of standing and is of dubious precedential value for the conclusion that equity securities of different entities should be matched in order to invoke liability under the statute.

There are nevertheless instances where a court would appear to be justified in treating two related entities as a single “issuer” for purposes of Section 16(b). This is consistent with the general approach of the courts to interpret the statute by focusing upon the substance of a particular transaction notwithstanding its form. This pragmatic approach to the interpretation of the term “issuer” could also serve to relieve an insider from potential statutory liability under some circumstances. An analogy may be drawn to the Second Circuit’s holding in Blau v. Mission Corp. that a corporate insider did not effect a “sale” of the shares of the issuer upon transferring them to the insider’s wholly-owned subsidiary (in exchange for shares of the subsidiary), because there was merely a transfer “between corporate pockets.” This holding was extended by Blau v. Lamb to a 97%-held subsidiary of the corporate parent, the court indicating that, while it could not fix a precise limit with respect to this question, the transfer of securities to such subsidiary in no way increased the corporate insider’s potential ability to abuse inside

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91 Id. at 883-84.
92 See generally SEC Rule 16b-7, which exempts from § 16(b) the acquisition and disposition of securities pursuant to certain parent-subsidiary mergers. It contains the following:

(c) Notwithstanding the foregoing, if an officer, director or stockholder shall make any purchase (other than a purchase exempted by this rule or any other rule under Section 16(b) of the Act) of a security in any company involved in the merger or consolidation and any security (other than a sale exempted by this rule or any other rule under Section 16(b) of the Act) of a security in any other company involved in the merger or consolidation within any period of less than 6 months during which the merger or consolidation took place the exemption provided by this rule shall be unavailable to such officer, director, or stockholder to the extent of such purchase and sale.

17 C.F.R. § 240.16b-7(c) (1973).
94 363 F.2d 507 (2d Cir. 1966), cert. denied, 385 U.S. 1002 (1967).
information. Nevertheless, it would not appear reasonable to apply the approach derived from the foregoing decisions to factual situations such as Crane, where the two merged entities were unrelated prior to the merger.

E. The Relationship Between Kern and Reliance

The significance of Kern should also be assessed in light of the Supreme Court's 1972 decision in the case of Reliance Electric Co. v. Emerson Electric Co. In Reliance, the Court employed an automatic approach to the interpretation of statutory language which appears to sanction the splitting of transactions by a more-than-10% holder of the issuer's securities. Reliance arose out of an aborted attempt by Emerson to acquire control of Dodge Manufacturing Company. Pursuant to a tender offer, Emerson acquired approximately 13% of the outstanding common shares of Dodge. However, the management of Dodge rejected Emerson's offer and agreed to merge with Reliance. After Dodge shareholder approval had been obtained, Emerson embarked upon a plan admittedly calculated to minimize its Section 16(b) liability. It arranged for two separate cash sales of its Dodge shares, the first of which reduced Emerson's holdings below the 10% level; the second sale was effected shortly thereafter. Both sales of the Dodge shares occurred within six months of their purchase. The Supreme Court held that the second sale was beyond the purview of the statute. Although Reliance may at first appear inconsistent with Kern, Section 16(b) is expressly made inapplicable to "any transaction where [the more-than-10% shareholder] was not such both at the time of the purchase and sale . . ." By reason of this express statutory caveat and the fact that all of Emerson's purchases or sales consisted of cash transactions, the two decisions can be reconciled. There is nothing in the Court's decision in Reliance which suggests that Section 16(b) requires an automatic approach when extraordinary, non-cash transactions are under scrutiny. Indeed, the fact that the Kern decision was rendered within a year after Reliance indicates that the Court did not view its decision in Reliance as representing anything other than an interpretation of the application of the statute to cash transactions in the context of the express statutory caveat.

While the holding in Reliance appears to be justified, the decision has troubling implications, particularly if one of the two or more split transactions undertaken by the holder of more than 10% of the shares involves a non-cash transaction. The interpretation of the express statutory caveat in Reliance, if applied to a non-cash transaction occurring in a series of split purchases or sales of securities, could lead to uneven results regardless of whether the potential for unfair insider trading, as defined by the Court in Kern, is prevalent in all such instances. It is appropriate to note that some insiders, such as Occidental and Crane which held more than 22% and 32%, respectively, of the outstanding shares of target companies which they sought to, would have found the statutory caveat of limited, if any, comfort, whereas other insiders, such as Emerson,
which held but 13% of the target company's outstanding shares, could rely on the caveat.\(^9^9\) Under these circumstances, it remains to be seen how the courts will react in the future to an extraordinary, non-cash transaction where the speculative abuse test would presumably be applicable, but where the 10% holder would seek to rely on the statutory caveat. As a practical matter, future tender offerors confronted by hostile managements will follow the splitting technique which *Reliance* sanctions if their holdings of the issuer's shares are not so substantial as to make splitting economically inadvisable. If the transaction does not lend itself to splitting, other methods may be used to avoid Section 16(b) liability, including postponing the consummation of the reorganization beyond the statutory period or attempting to structure the transaction in accordance with the tests of *Kern.*\(^1^0^0\)

Another aspect of the *Reliance* decision which is potentially troubling is reflected in the dissenting opinion in which Justice Douglas sought to apply the speculative abuse test to ordinary cash transactions and purchases of securities.\(^1^0^1\) This position seems to be inconsistent with the definition of the test enunciated in *Lamb\(^1^0^2\)* and *Kern.*\(^1^0^3\) If the speculative abuse test were applied to the facts of *Reliance*, it is arguable, particularly in light of *Kern*, that since Emerson was not privy to inside information and did not control the course of the Dodge-Reliance defensive merger, there was no potential for speculative abuse on the part of Emerson.\(^1^0^4\)

It is nevertheless doubtful that a court would apply the speculative abuse test to cash transactions within the statutory period.\(^1^0^5\) However, the problem of whether

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\(^9^9\) See id. at 300 n.48.

\(^1^0^0\) With respect to the question of splitting securities transactions, the *Proposed Federal Securities Code* would overrule the result reached in *Reliance* by providing that *section [1413] applies with respect to (1) a purchase that makes a person a more than 10 percent owner . . . and (2) a sale within less than six months after the purchase whether or not the seller had that status at the time of sale.*

\(^1^0^1\) See 363 F.2d 507, 514-20 (2d Cir. 1966), cert. denied, 385 U.S. 1002 (1967).

\(^1^0^2\) See 411 U.S. at 591-95.

\(^1^0^3\) See 404 U.S. at 420.

\(^1^0^4\) The Supreme Court in *Kern* seems to have disposed of the possibility of applying the speculative abuse test to ordinary cash transactions:

> Once the merger and exchange were approved, Occidental was left with no real choice with respect to the future of its shares of Old Kern . . . . Occidental could, of course, have disposed of its shares of Old Kern for cash before the merger was closed. Such an act would have been a § 16(b) sale and would have left Occidental with a prima facie § 16(b) liability.

\(^1^0^5\) See 411 U.S. at 600 (emphasis supplied).

\(^{411}\) See Schur v. Salzman, CCH CURRENT FED. SEC. L. REP. ¶ 94,370, at 95,257 (S.D.N.Y. 1973). In *Schur*, the defendant, an insider of Odell, Inc., sold his controlling block of shares of that corporation to Papercraft Corp. In addition, the defendant agreed to (1) resign as an officer and director of Odell; (2) use his best efforts to amend Odell's by-laws with respect to directors; (3) cause all but five directors to resign and a named individual to be elected Chairman of the Board of Odell; and (4) waive his right to salary from Odell under an employment agreement. The sale occurred within six months of purchases by the defendant of Odell shares. Subsequently, Odell was merged into Papercraft. The defendant argued that his sale transactions were "beyond the pale of section 16(b) because they were not the usual 'garden-variety' type . . . ." *Id.* at 95,258. Despite the fact that purchase and sale transactions were made solely for cash, the court, in rejecting the defendant's contention, noted that considering defendant's insider position, his special knowledge of the facts surrounding
the split transactions constitute "legally tied" sales, which was alluded to by the Court in *Reliance*, may be disposed of by an inquiry into the substance of the transactions similar to that involved in the application of the speculative abuse test.\textsuperscript{106}

**F. Illustrative Problem Areas**

Several problems arise in attempting to extend the rationale of *Kern* to other factual settings. While *Kern* found no liability in the context of a transaction involving two competing bids for control of an issuer, *Newmark* and *Gold* indicate that liability under Section 16(b) may be imposed for securities transactions in non-contested reorganizations. Questions remain concerning the application of the speculative abuse test to those transactions which may be the subject of a contest between two or more competing groups, but where the specific insider occupies a neutral position or where the relationship between the insider and management, or other competing control groups, vacillates during the relevant period. In addition, it remains to be seen what weight will be given by the courts to either of the "access-control" variables or whether the other legitimate considerations noted elsewhere in this article will be evaluated in determining whether Section 16(b) liability should be invoked in a particular corporate reorganization.

The following prototype situations may be instructive in seeking answers to these questions:

1. \(X\) purchases for cash more than 10% of the outstanding securities of Corporation \(A\), and thereby becomes a statutory insider. At the time of acquisition of that block of securities, \(X\) also obtains control of \(A\)'s board of directors. \(X\), after reviewing \(A\)'s prospects, believes that it is in the best interests of \(A\) and all of \(A\)'s shareholders to merge with a larger and financially stronger company. Within six months of his purchase, \(X\) arranges a merger of \(A\) into Corporation \(B\) pursuant to which \(B\) issues its equity securities to the shareholders of \(A\). This merger was not contemplated at the time that \(X\) acquired his status as a statutory insider of \(A\), but \(X\) plays a significant role in the decisions affecting the merger. \(X\) derives no benefit under the terms of the merger which is not shared equally by other holders of the same classes of securities of \(A\). Although \(X\) can demonstrate that the purchase of more than 10% of the shares of \(A\) was not made in contemplation of the merger, it would appear that his control relationship and access to inside information concerning \(A\), as well as his ability to influence the terms of the merger, will likely result in the imposition of liability in light of Papercraft's interest in acquiring Odell, his participation in the negotiations, and his awareness that his shares ... were deemed vital by the acquiring interests, there existed the possibility of abuse of inside knowledge ...

Newmark and Gold. The statutory presumption cannot be rebutted by contentions based upon the notion that \( X \) has not abused his control position or unfairly appropriated inside information for his own benefit, as potential, rather than actual, abuse is the governing criterion under the test.

(2) \( X \) has become a statutory insider of Corporation \( A \) by virtue of his purchases of more than 10% of the outstanding shares of \( A \). \( X \) has no control of the issuer’s board of directors and must contend with a hostile management group competing for control of \( A \). The antagonism between \( X \) and the other competing control group can only be resolved through the arrangement by the competing group of a merger of \( A \) into Corporation \( B \) within six months of the date from which \( X \) became a statutory insider. \( X \) is not aware of the proposed merger prior to its public announcement, and has little, if any, power to thwart its consummation. Throughout this period, \( X \) has continued to purchase shares of \( A \) in an effort to outbid the competing group for ultimate control. In this instance, the facts are considerably closer to those confronting the Supreme Court in Kern, and it is arguable that an application of the speculative abuse test should result in the absence of liability under the statute. Here, the finding might turn upon whether \( X \), the statutory insider, is able to exert such influence upon the transactions resulting in the merger as to be comparable to RKO in Newmark or Sloan in Gold. It would appear that the Crane counterargument that \( X \), in continuing to purchase securities during the relevant period, realizes that he can reap profits from the contest for control of \( A \), has been repudiated by the Supreme Court’s holding in Kern that such short-swing profit calculations not derived from inside information are not with the purview of the concept of speculative abuse.  

\[ 107 \]

However, where it can be demonstrated that \( X \) has such access, despite the fact that the hostile competing group is solely responsible for arranging and negotiating the merger, \( X \) might be held liable under Kern.  

(3) \( X \), an officer or director of Corporation \( A \), purchases shares of \( A \) within six months prior to a merger of \( A \) into Corporation \( B \). \( X \) exercises no perceptible control over the timing or terms of the extraordinary transaction and does not have access to the kind of confidential information which Kern deems determinative. Gold suggests the appropriateness of a case-by-case analysis of the particular insider’s access to confidential information. It would appear that \( X \) would be more likely to succeed in rebutting the statutory presumption of access if he were in a position analogous to that of Occidental in Kern, rather than an officer or director of \( A \), involved in the daily functions of corporate management.  

\[ 109 \]

\[ 108 \] The failure to rebut the presumption of access to inside information would, in itself, seem sufficient under Kern for the imposition of liability. See 411 U.S. at 598-99.

\[ 109 \] A variation of this case would occur where the only information concerning the reorganization that \( X \) receives comes as a result of public statements made by the issuer. The analysis of the majority in Gold with respect to the defendant, Scurlock, emphasized that he obtained information concerning the issuer on substantially the same basis as all other shareholders. [1973 Transfer Binder] CCH Fed. Sec. L. Rep. 794,186, at 94,796 (4th Cir. 1973). The dissent, however, argued that

[the statute draws no distinction between "active" and "passive" directors and, in the absence of evidence that a director did not in fact discharge the duties normally associated with that position, a conclusion that a director was not privy to inside
(4) $X$ has become a substantial shareholder of Corporation $A$ prior to the time that $A$'s management proposes to effect a merger with Corporation $B$. The shares of $X$ may constitute the crucial "swing vote" necessary to obtain approval of the merger by $A$'s shareholders. $X$ does not have knowledge of the impending merger at the time he effects his cash purchases of the shares of $A$. The question presented is whether Section 16(b) liability may be affected by the manner in which $X$ votes. The Supreme Court in *Kern* carefully noted the actions taken by Occidental at the Kern shareholders' meeting which approved the reorganization. The Court observed that under the applicable state law Occidental's abstention was tantamount to a negative vote but that dissenters' appraisal rights were not available to it. However, since Kern had the necessary votes to effect the merger without the favorable votes of Occidental, the Court was not obliged to pass upon the effects of its action at the shareholder level.

Where a shareholder's negative vote, or an abstention which is tantamount thereto, would represent a futile effort to defeat a proposed reorganization, there would seem to be no reason in law to require it. Where the ultimate approval respecting the reorganization may be dependent upon the insider's vote, the rationale for imposing liability upon the insider who votes in favor of the transaction would be based upon a concept of control. "Control" in this context would necessarily consist of the power to thwart the consummation of the reorganization rather than the power to arrange for and negotiate the transaction. However, this argument appears to overlook the *Kern* analysis that the concept of control subsumes access to inside information. Moreover, if a finding of control were based solely upon the power to block a reorganization, the insider, in order to avoid Section 16(b) liability, might well be inclined to take action to attempt to thwart a transaction which may well be of benefit to all shareholders of the corporation. Nevertheless, careful practitioners, representing an insider holding the "swing vote" in a contested or non-contested reorganization, might recommend

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*Id.* at 94,805.

It remains unclear as to the type of inside information with which the statute is concerned. The majority in *Gold*, focusing on pre-merger relationships, seems to have confined its analysis to inside information with respect to the particular reorganization transaction. In analyzing the defendant, Sloan, the majority stated that the only relevant distinction to be made between Sloan and the other defendants... is that Sloan possessed specific financial information concerning ARC and Susquehanna between the date of the August directors' meeting of ARC and the distribution of the proxy statement in October. Sloan, and no other defendant, had knowledge of certain inside information that would have helped him to predict the future performance of Susquehanna; such knowledge is the source of his "possibility of speculative abuse"... .

*Id.* at 94,801 (emphasis supplied).

The dissent, in analyzing the possibility of speculative abuse during the post-merger period, appears to have been concerned with the varying relationships of the insiders to the corporation, i.e., Susquehanna in general. *Id.* at 94,602-07.

110 *Id.* at 599. In *Gold*, the majority refused to impose liability upon the defendant, Scullock, despite the fact that he cast the deciding vote in favor of a resolution of the ARC Board of Directors submitting the proposed merger with Susquehanna to the ARC shareholders for approval. [1973 Transfer Binder] CCH Fed. Sec. L. REP. ¶ 94,186, at 94,794-99 (4th Cir. 1973); *cf.* *id.* at 94,804-05 n.3 (dissenting opinion).
that the insider avoid any implication of speculative abuse by at least abstaining from voting with respect to the proposed merger.\textsuperscript{112}

Judicial guidance has enabled insiders and their counsel to make informed judgments as to the appropriate course to follow in order to avoid liability under Section 16(b). As these prototypes illustrate, however, significant interpretative problems in the area of non-cash, extraordinary transactions still remain.

III. Insider Transactions in Options and Other Stock Rights

The statutory consequences of insider transactions in put and call options and other stock rights\textsuperscript{113} represent another significant concern under Section 16(b). A put option is a contract giving the holder the right to sell to the writer of the contract a certain number of shares of an issuer's securities at a fixed price on or before a certain date. A call option is a similar contract giving the bearer the right to buy securities. Both types of option contracts are ordinarily sold by the writer for a "premium," determined by the price of the shares, past and projected market fluctuations, and the difference or "spread" between the option's exercise price and the prevailing market price of the underlying shares.\textsuperscript{114}

In contrast to corporate reorganizations, which typically are "extraordinary" transactions not readily identified as a "purchase" or "sale," ordinary insider trading for cash in transferable put and call options, warrants, and other stock

\textsuperscript{112} The defendant by casting a negative vote and demanding appraisal rights, would seem to be exposing himself to potential § 16(b) liability. Since there is no reason to suppose that a cash sale of the issuer's securities back to the issuer at the initiation of the seller is not a § 16(b) "sale," the defendant would be confronted with an unrealistic alternative of prima facie § 16(b) liability as opposed to a subjective analysis into the transaction as a whole. See generally \textit{41 U.S. at 600. Moreover, the value of the dissenters' shares for appraisal purposes is determined subsequent to the dissenters' applying therefor. See, e.g., Del. Gen. Corp. Law § 262(b), (c) (1973), which provides that an appraiser will be appointed by the court if the dissenters and the corporation are unable to agree upon the value of the dissenters' shares. A dissenting shareholder may subsequently withdraw his objections and participate in the merger or consolidation if he obtains the written consent of the corporation. See id. § 262(i). There seems to be no basis in requiring the dissenters to gamble upon the determination of a court-appointed appraiser as against the "merger-determined value" when he has not participated in determining the latter. \textsl{See generally Ferraio1o v. Newman, 259 F.2d 342, 346 (6th Cir. 1958), cert. denied, 359 U.S. 927 (1959). Moreover, even if a sale is deemed to have occurred, the question arises as to the appropriate date of sale. The "irrevocably bound" test, \textsuperscript{114} infra, is of little aid if the dissenting shareholder is permitted to withdraw his objections and participate in the reorganization transaction. If the date of actual transfer of shares for cash is used, the transaction may very well be outside the six-month period of § 16(b). \textsuperscript{See note 154 infra. The Proposed Federal Securities Code specifically exempts "an incidental cash sale pursuant to dissenters' appraisal rights" from the insider short-swing proscriptions of § 1413, subject to the defendant's proving that "he did not use information obtained by reason of his relationship to an involved issuer." \textit{Allis-Chalmers Mfg. Co. v. Gulf & West. Indus., Inc., CCH CURRENT FED. SEC. L. REP. \| 94,421, at 95,430 (N.D. Ill. Jan. 30, 1974) (distinguishing Kern on the ground that Occidental's "sale" in Kern was involuntary).}

113 The term "other stock rights" is used in this article to include all transferable and non-transferable employee stock options, stock warrants, and other stock acquisition rights. See \textit{E. Filber, UNDERSTANDING PUT AND CALL OPTIONS} 20-24 (1959); Comment, \textit{Put and Call Options under Section 16 of the Securities Exchange Act}, 69 YALE L.J. 868, 869 (1960) [hereinafter cited as 1960 YALE Comment].
acquisition rights appears to pose no special problems under Section 16(b). However, transferable options, unlike convertible securities, are securities which may be purchased or sold separately from the underlying shares. Since trading in transferable options is thus the functional equivalent of a purchase and sale of the underlying securities, the statutory presumption of abuse of inside information appears appropriate where an insider has derived short-swing profits from the cash purchase and sale of a transferable put or call option within six months. The potential for insider speculation may be considerably increased through the use of put and call options because the premium for an option is typically small in relation to the value of the underlying securities, and short-term market fluctuations in such securities are usually reflected in the cost of the option. While there previously was some question whether all transferable options and other stock rights could be considered "equity securities of such issuer" within the meaning of Section 16(b), a 1973 SEC amendment to Rule 3a11-1 now confirms that put and call options are within the Exchange Act's definition of "equity security."
However, the application of Section 16(b) to insider option transactions has been much less clear where an insider has not both purchased and sold the options for a profit and where the only matchable transactions within the statutory six-month period are the insider’s acquisition or disposition of the option and his cash sale or purchase of the underlying securities. Such “extraor-
certificate of interest or participation in any profit sharing agreement, preorganization certificate or subscription, transferable share, voting trust certificate or certificate of deposit for an equity security, limited partnership interest, interest in a joint venture, or certificate of interest in a business trust; or any security convertible, with or without consideration into such a security, or carrying any warrant or right to subscribe to or purchase such a security; or any such warrant or right; or any put, call, straddle, or other option or privilege of buying such a security from or selling such a security to another without being bound to do so.

SEC Sec. Ex. Act Rel. No. 10129, SEC Reg. § 240.3a-11, 38 Fed. Reg. 11449 (1973) (emphasis supplied). Although the amendment was primarily intended to make it clear that the Federal Reserve Board has authority under § 7(d) of the Exchange Act, 12 U.S.C. § 78g(d) (1970), to regulate the extension or maintenance of credit by banks with respect to such options, see SEC Sec. Ex. Act Rel. No. 10129 (1973), the revised definition of “equity security” is generally applicable throughout the Exchange Act.

Even after the amendment to Rule 3a11-1 specifically including put and call options within the definition of “equity security,” it could be argued that privately issued puts and calls should not be deemed “equity securities of such issuer” (emphasis supplied) within the meaning of § 16(b) since the “issuer” referred to is clearly the corporation whose securities are registered under the Exchange Act rather than the issuer of the options. The amended Rule makes no explicit reference to the “issuer” question, although the revised definition appears to contemplate that the options will be deemed equity securities of the issuer of the underlying shares. In any case, it has been generally acknowledged that private puts and calls are within the scope of § 16(b) because the word “of” can reasonably be construed to mean “relating to” or “pertaining to” rather than “issued by” the issuer’s corporation. See Laufer, Effect of Section 16(b) of the Securities Exchange Act on Use of Options by Insiders, 8 N.Y.L. Forum 232, 236 (1962) (hereinafter cited as Laufer); 1960 YALE Comment, supra note 114, at 873-74.

The SEC recently has exhibited increased interest in regulating the issuance and trading of put and call options. New SEC Rule 9b-1, effective January 7, 1974, prohibits all exchanges and exchange members from trading in any options unless such option trading is conducted pursuant to a plan declared effective by the Commission. See SEC Sec. Ex. Act Rel. No. 10552, SEC Reg. § 240.9b-1 (1973). See also Proposed Reg. § 230.238, SEC Sec. Act Rel. No. 5366 (1973) (Proposed Rule 238 promulgated under the Securities Act of 1933, which would provide an exemption from the registration requirement of that Act for the options meeting certain specified conditions); Proposed Reg. § 240.9b-2, SEC Sec. Ex. Act Rel. No. 9994 (1973) (Proposed Rule 9b-2 promulgated under the Exchange Act, which would establish certain suitability, disclosure, net capital and reporting requirements applicable to broker-dealers engaging in option transactions).

Prior to the amendment to Rule 3a11-1, it was suggested that if an option is itself a security, it may be possible to match transactions in the underlying shares and in the option on the ground that both transactions are in securities of the issuer of the same class. 2 Loss, supra note 3, at 1059-60. See Chemical Fund, Inc. v. Xerox Corp., 377 F.2d 107 (2d Cir. 1967) (an issuer’s common shares and convertible debentures are equity securities of the same class so that for the purposes of determining beneficial ownership of the class, an insider’s common shares may be aggregated with the number of common shares into which the debentures it owns are convertible); Simon v. Sunasco, [1969-1970 Transfer Binder] CCH Fed. Sec. L. REP. ¶ 92,547 (S.D.N.Y. 1970) (an insider was the indirect owner of the common shares into which the special shares that it held were then convertible).

Furthermore, it has been urged that it may be possible to match an insider’s acquisition or disposition of an option with his transaction in the underlying securities because the option is, in effect, a contract to purchase or sell the underlying securities. 1972 GEORGIA Note 159-62. Under this view, an insider’s sale of the underlying securities would be matched with his acquisition of a call option, which would be deemed a “contract to buy, purchase, or otherwise acquire” the underlying securities within the Exchange Act’s definition of “purchase.” 15 U.S.C. § 78c(a)(19) (1970); see note 10 supra. Conversely, an insider’s purchase of the underlying securities would be matched with a put option, which would be deemed a “contract to sell or dispose of” the underlying securities within the meaning of the definition of “sale.” 15 U.S.C. § 78c(a)(14) (1970); see note 11 supra. Similarly, the insider’s grant of a call option would be deemed a “sale” which could be matched with his purchase of the underlying securities, and his grant of a put option would be deemed a “purchase” of the underlying securities which could be matched with their sale. It has been suggested, however,
dinary" insider option transactions have been most notable in two clearly distinct contexts. First, in the area of corporate reorganizations, prospective tender offerors, who became statutory insiders by purchasing more than 10% of an issuer's equity securities, have occasionally found it advantageous (for reasons related to the attempted bid for control) to either acquire or grant a call option for a large block of such securities within six months of their cash purchases thereof. Their motives in acquiring or granting such options have included the desire to lock up a sufficient number of shares of the issuer to assure the success of the attempt to obtain control of the issuer or to be extricated from a minority position in a larger corporation which has blocked the prospective acquirer's tender offer by merging with the issuer. The second major open area is whether Section 16(b) consequences should attach to an insider's acquisition of employee stock options from an issuer where the options are not resold by the insider for cash. The acquisition of employee options may be deemed to constitute an "extraordinary" transaction for Section 16(b) purposes because such options are rarely acquired for cash and are granted by the corporation for purposes which are not related to insider short-term speculation.

that an option may represent nothing more than an offer to purchase or sell the underlying securities. See 1960 YALE Comment, supra note 114, at 884.

In any event, the attempted characterization of an option as a "contract to buy" or a "contract to sell" has not been adopted by the decisions construing the application of § 16(b) to insider option transactions. In Silverman v. Landa, 306 F.2d 422 (2d Cir. 1962), a shareholder attempted to recapture the premiums realized by a director from his simultaneous grant of call options for 1,000 shares and put options for 500 shares. Finding for the defendant, the court held that the insider's grant of the put and call options could not be deemed a "purchase" and "sale" of his shares of the corporation because the options were one-sided, fixing the obligations but not the rights of the insider, and because the insider at no time could control whether the options would be exercised. The court further held that even on the assumption that either half of the straddle was itself an "equity security," there was no sale or purchase for § 16(b) purposes because the call was never exercised and the put was exercised more than six months from the date of grant. Id. at 424. The court did not even consider the rather obvious possibility of matching the issuance of the puts as a "contract to sell" with the issuance of the calls as a "contract to buy" the insider's securities. See also cases cited at text accompanying notes 125 to 138 infra.

124 See text at note 180 infra. In contrast, there are other types of "extraordinary" insider option transactions—in which the only matchable transactions within the statutory six-month period are the insider's acquisition (or disposition) of an option and his cash sale (or purchase) of the underlying securities—where the potential to realize speculative profits is more apparent. For example, it has been suggested that insiders have the ability to manipulate options to realize speculative profits in so-called "profit-freezing" transactions: An insider who has appreciated securities and inside information that the value of his shares will decline can freeze his profit without engaging in a prohibited sale within six months of his purchase by acquiring a put option at the then current market price. The insider can then exercise the put option after the shares have declined in value and after six months has run from his initial purchase of the shares. He would thus realize all the profit he could have realized through his sale of the shares at the time he acquired the inside information, less only the minimal premium he paid for the option. 1960 YALE Comment, supra note 114, at 883-880.

These possible insider option transactions have not appeared in the decisions. However, it is likely that in the future insiders realizing profits from such transactions would be deemed liable under § 16(b) on the ground that the transactions are not significantly different from ordinary insider trading in options and thus present the potential for speculative abuse under the test adopted by the Supreme Court in Kern. See text accompanying note 130 infra.
A. Option Transactions Related to Corporate Reorganizations

In three decisions in 1970 and 1971, the Second and Seventh Circuits were confronted with the issue of the proper treatment under Section 16(b) of an insider's acquisition or grant of a call option in the context of contested or non-contested bids for corporate control. This series of decisions culminated in the Supreme Court's explicit application of the "speculative abuse" test to such option transactions in its *Kern* decision in 1973.

In *Newmark*, the Second Circuit held that RKO's option to acquire the controlling block of Central securities constituted a "purchase" which could be matched with its "sale" of the shares occasioned by the merger of Central into Frontier within six months thereafter. However, because RKO's acquisition of the option, its exercise of the option, and the merger all took place within a period of six months, it was not necessary for the court to determine whether the "purchase" occurred upon the date of the option's grant or its exercise. The Seventh Circuit considered that very question in *Bershad v. McDonough*, where a husband and wife, who collectively owned more than 10% of the outstanding shares of an issuer, granted a call option to a prospective acquiring corporation within six months of the grantors' cash purchases of such shares, but where the grantee's exercise of the option occurred after the expiration of that six-month period. Examining all the circumstances in order to determine whether the grant of that option amounted to a "sale" of the underlying shares for Section 16(b) purposes, the court held that the large size of the "binder" paid for the option, representing more than 14% of the total purchase price of the shares, the grant of irrevocable proxies to the grantee to vote the shares subject to the option at any regular or special shareholders meeting, and the replacement of the grantors with the designees of the grantee on the issuer's board of directors were sufficient to "clearly indicate that the stock was effectively transferred, for all practical purposes, long before the exercise of the option."

The Supreme Court was faced with an analogous option transaction in *Kern* because, while Occidental's grant of a call option on Tenneco preference shares occurred within six months of its cash tender offer purchases of Kern shares, the option could not be exercised until six months after the date of grant. The plaintiff in *Kern* suggested two grounds for imposing insider liability.

125 See *Newmark v. RKO General, Inc.*, 425 F.2d 348, 354 (2d Cir. 1970):
Since all of the events . . . transpired within a six-month span during the year 1967, any purchase and sale which formed a part of these events occurred within the statutory period. Similarly, by any rational definition, RKO's exchange of $7,550,082.50 in cash for Central's common stock and convertible debentures was a "purchase" of those securities.

126 428 F.2d 693 (7th Cir. 1970), cert. denied 400 U.S. 992 (1971).
127 428 F.2d at 698.
128 Id. at 697 n.5.
129 See 59 Ky. L.J. 1015-17 (1971).
Adverting to the "speculative abuse" test, it urged that Occidental's purchase of the Old Kern shares and grant of a call option to Tenneco within six months "was the kind of transaction the statute was designed to prevent . . . ." The Supreme Court held that it did not "find in the execution of the Occidental-Tenneco option agreement a sufficient possibility for the speculative abuse of inside information with respect to Old Kern's affairs to warrant holding that the option agreement was itself a 'sale' within the meaning of § 16(b)." The Court noted that, while the execution of the option had "mutual advantages" for both Occidental and Tenneco, the motivation of the grantor—the elimination of its minority position in Tenneco—did not "smack of insider trading" for the purpose of realizing speculative profits. The Court also emphasized that, even assuming that Occidental had inside information because of its "leverage" in dealing with Old Kern and Tenneco, no Section 16(b) liability should attach because it was demonstrated that there was no potential abuse of Occidental's position as a statutory insider. Because the option was a call option, "Occidental could not share in a rising market for the Tenneco stock"; at the time of the grant of the option, "Occidental had no ownership position in Tenneco giving it any actual or presumed insights into the future value of Tenneco stock"; because the earliest date for the exercise of the option was more than six months after its grant, there was a statutory presumption that whatever trading advantages Occidental possessed at the date of grant would be dissipated before exercise; at the time of the grant, there was no absolute assurance that the merger would be effected, so that the option itself could become "null and void."

Citing Bershad, the plaintiff in Kern also argued that "the agreement [between Occidental and Tenneco] was an option in form but a sale in fact." The Court noted that, while the plaintiff's argument "has force," recharacterization is purely a factual question, "very much a matter of judgment, economic and otherwise," and it refused to reverse the Second Circuit's holding that Occidental's grant of the option did not constitute a sale of the underlying shares. The Court distinguished Bershad on the ground that the Second Circuit had found in Kern that, based on expert testimony, the premium paid to Occidental constituted a fair value of the cost of that type of option, there was a real possibility on the date of grant that the option might never be exercised, the optionor "did not surrender practically all the emoluments of ownership by executing the option," and there were no "other special circumstances" indicating that the parties understood and intended that the option was the equivalent of a sale.

Citing language from the Second Circuit's Kern opinion, the Court noted

131 Id.
132 See Goodman, The Occidental Case, 18 Rev. Sec. Reg. 851, 855 (1973). The insider position argument appears to be the complement of the Supreme Court's holding that there was no potential for speculative abuse in the exchange of shares pursuant to the merger of Old Kern and Tenneco because Occidental had no control over the merger negotiations. See text accompanying note 37 supra.
133 411 U.S. at 601-03.
134 Id. at 601.
135 Id. at 603-04.
that, unlike Bershad, the Occidental option was not "accompanied by a wink of the eye . . . ."\textsuperscript{136}

1. Consequences of the Grant or Acquisition of the Option

The Supreme Court thus appears to have set forth two separate, but interrelated, tests for the imposition of Section 16(b) liability in the context of a corporate reorganization where the insider's grant of an option, but not its exercise, has occurred within six months of the insider's "purchase" (or "sale") of the underlying shares either for cash or pursuant to the reorganization: whether the transaction could lead to "speculative abuse" or whether the grant of the option was in effect a disposition of the underlying securities. With respect to the "speculative abuse" standard, the Court's refusal to match Occidental's grant of the option for the Tenneco shares with its prior cash purchase of the Kern shares establishes that the fact that the insider granted an option for a cash premium in a transaction which was not made available to other holders of the same class of securities would not, in itself, be sufficient to trigger Section 16(b) liability.\textsuperscript{135} However, as noted elsewhere in this article,\textsuperscript{138} it appears that the distinction drawn by the Court between inside information and status as a statutory insider will benefit a more-than-10% shareholder only where the management of the issuer opposes that shareholder's bid for corporate control. In cases such as Newmark and Bershad, where the management of the issuer facilitated either the takeover of control or the reorganization, the potential for speculative abuse is more likely to be found because the acquiring corporation would ordinarily be unable to rebut the statutory presumption that it had either access to undisclosed inside information or some meaningful element of control in the process of effecting the takeover.

Whether or not the corporate takeover attempt is opposed by the issuer's management, it is suggested that one of the implications of Kern and Newmark is that the potential for speculative abuse is more likely to be found if the insider is a grantee, rather than a grantor, of an option. The Kern Court's conclusion that there was little potential for Occidental to engage in speculative abuse because its grant of a call option "by its very form, left Occidental with no choice but to sell if Tenneco exercised the option,"\textsuperscript{139} can be read as an indication that the Court might, under some circumstances, deem the grantee's discretion to exercise the option or permit it to expire to constitute the potential for insider abuse.

\textsuperscript{136} Id. at 604 n.30, quoting Abrams v. Occidental Petroleum Corp., 450 F.2d 157, 165 (2d Cir. 1971).

\textsuperscript{137} See text accompanying notes 74 to 82 supra.

\textsuperscript{138} See text accompanying notes 45 to 61 supra.

\textsuperscript{139} 411 U.S. at 602.
Nevertheless, because the Court refused to adopt a rigid definition of "speculative abuse" and looked to all the surrounding circumstances of the Occidental-Tenneco option, it is probably still open to a grantee of a put or call option to attempt to avoid Section 16(b) liability by demonstrating either that the hostile attitude of the issuer's management negated the possibility of access to inside information or that there were non-speculative motives for the acquisition and exercise of the option. 144

While the parameters of the "speculative abuse" standard as applied to options in the reorganization context are still somewhat unclear, the Supreme Court's articulation of the second test—whether the option agreement was in fact a sale of the underlying securities—appears to be a more useful guide for planning purposes. It seems that an insider, either as a grantor or grantee, can guard successfully against a subsequent finding that the grantor surrendered "practically all the emoluments of ownership" of his shares through a careful structuring of the option arrangements which avoid the indicia of sale in light of Bershad and Kern. 142 Accordingly, the parties should avoid including in the option contract the provisions which were held by the Bershad court to be tantamount to the transfer of beneficial ownership of the shares—the execution by the grantor of an irrevocable proxy for his shares in favor of the grantee and the immediate resignation of the insider grantor from the board of directors of the corporation. Although the Supreme Court in Kern did not specify what other special circumstances might lead to a finding that the grant of the option "was accompanied by a wink of the eye" and was in fact a sale of the shares, it appears that, in the absence of contract provisions or other collateral arrangements clearly pointing to a surrender of the indicia of ownership, a reviewing court will and should ignore the labels or technical forms utilized by the parties.

140 The Court's emphasis on the fact that the Occidental-Tenneco option was a call may be misplaced. It does not appear that the grant of a put provides the insider-grantor with more potential for speculative abuse under the Court's "no choice" rationale than does the grant of a call, because the obligations of the grantor are fixed in both situations.

141 It has been suggested, for example, that a retiring controlling shareholder of a corporation may seek to use stock options as a device to pass control to a particular individual or group of insiders. See Laufer, supra note 120, at 241. It appears that the motive of realizing speculative profits could not reasonably be attributed either to the grantor or the grantee of the options in such a situation.

142 The Bershad test also has implications under § 16(c) of the Exchange Act, which provides that

\[\text{[April 1974]}\]
and attempt to ascertain the substance of the transaction. Special circumstances suggesting that the grant of the option was in fact a sale of the shares would appear to include a finding either that the premium for acquisition of the option was so substantial as to constitute a down payment or that the exercise price of the option was so insubstantial that it would be unlikely from a realistic business viewpoint for the grantee to elect not to exercise the option.

2. Consequences of Exercising the Option

The Supreme Court's adoption of a flexible approach to option transactions in the corporate reorganization context raises the question of whether the courts will continue to adhere to the automatic doctrine that an insider's acquisition of shares for cash upon exercise of the option will always be deemed a "purchase" which may be matched with a cash sale of the underlying securities within the statutory period. Since the Kern decision applied the "speculative abuse"

143 The Bershad and Kern decisions appear to endorse a new test for ascertaining an insider's holding period with respect to shares subject to option. Prior decisions have held that an insider is deemed to have acquired beneficial ownership of shares through a "purchase" when he becomes "irrevocably bound" to complete the transaction. See, e.g., Blau v. Ogsbury, 210 F.2d 426 (2d Cir. 1954) (insider consummated a "purchase" of shares subject to option when he mailed notice to the issuer and "thereby incurred an irrevocable liability to take and pay for the stock"); Kramer v. Ayer, 317 F.Supp. 254 (S.D.N.Y. 1970) (insider did not acquire shares under a merger agreement until the requisite documents were filed with the appropriate officers of the interested states). See also American Agronomics Corp., 1971 WASH. SERV. BUR. INDEX (available May 24, 1971) (interpretative letter of SEC staff indicating that an insider acquires beneficial ownership of securities, for the purpose of reporting under § 16(a), when he takes a "firm commitment for the purchase thereof" but not if "certain conditions must be satisfied in order to make a transaction binding"). In contrast, Bershad and Kern indicate that the date of purchase (or sale) of shares subject to option will be related back to the date of acquisition (or grant) of the option if the "emoluments of ownership" of the shares have in fact shifted prior to exercise. It thus appears that, under such circumstances, a purchase of shares subject to option may be deemed to have occurred even if neither party was "irrevocably bound" on the date of grant to complete the transaction. See also Champion Home Builders Co. v. Jeffress, 416 F.2d 943 (6th Cir. 1969); Steinberg v. Sharpe, 95 F. Supp. 32 (S.D.N.Y. 1950), aff'd per curiam, 190 F.2d 82 (2d Cir. 1951); 1960 AM. STAFF INDIAN 1080; Rubin & Feldman, SERV. BUR. INDEX 876. For a decision applying the "irrevocably bound" test and the Bershad "incidents of ownership" test in holding that an insider did not acquire shares in a merger until the agreement between the acquired and acquiring corporations had been fully executed.

144 One example which illustrates the extent of Kern's departure from the traditional inquiries into the scope of purchase and sale under § 16(b) is the potential short-swing liability for an insider who has made a gift of an option which is subsequently exercised. Prior to Kern, it appears that a gift of an option could not be deemed a "purchase" or "sale" under § 16(b). The gift of the put or call could not be deemed a "sale" of the option itself, because it was early held that a gift is not a "sale" within the meaning of § 16(b). See, e.g., Shaw v. Dreyfus, 172 F.2d 140 (2d Cir.), cert. denied, 337 U.S. 907 (1949). Moreover, there was no potential for matching the insider's grant of the put or call with his sale or purchase of the underlying securities within six months, because the grant of the option could not be deemed a contract to sell within the definition of "sale" or a contract to purchase within the definition of "purchase" in view of the absence of consideration passing from the grantee to the grantor. In contrast, under Kern the gift could be deemed to have constituted a "purchase" or "sale" of the shares subject to option upon exercise either if there was a potential for insider speculative abuse or if exercise of the option was sufficiently certain to justify relating back the transaction in the shares to the date of the gift.

145 See, e.g., Shaw v. Dreyfus, 172 F.2d 140, 142 (2d Cir.), cert. denied, 337 U.S. 907 (1949); Steinberg v. Sharpe, 95 F. Supp. 32 (S.D.N.Y. 1950), aff'd per curiam, 190 F.2d 82 (2d Cir. 1951); 1960 YALE Comment, supra note 114, at 876. For a decision applying the doctrine to the exercise of employee stock options, see note 189 infra.

It should be noted, however, that the exercise of an option does not involve any "sale" of the option. See 2 Loss, supra note 3, at 1080; Rubin & Feldman, supra note 117, at 491. Furthermore, it has been held that because options are not the economic equivalent of the underlying shares, the acquisition of shares upon exercise of an option is not a "conversion"
standard in evaluating the grant or acquisition of options, it could be urged that the exercise of an option should not be deemed a "purchase" or "sale" for the purposes of Section 16(b) if it was effected for wholly non-speculative purposes (e.g., tax planning). The question gains added importance where the insider's exercise of options previously granted by the issuer may conceivably be matched only with an exchange of the equity securities underlying the option in a reorganization transaction, particularly if the insider was compelled by the impending reorganization either to exercise his outstanding options or to have them lapse entirely. In such event, it is arguable that neither transaction should be deemed a "purchase" or "sale" for Section 16(b) purposes if the insider could demonstrate that there was no potential for the abuse of inside information in the exercise of the options or the exchange of securities. However, as previously noted with respect to reorganization transactions, it appears that the "speculative abuse" test is relevant only where it is unclear whether an extraordinary, non-cash transaction should be deemed a "purchase" or "sale" within the meaning of Section 16(b). Since the exercise of the option typically involves a cash purchase or sale where realization by the optionor or optionee is manifest, the exercise probably could not be deemed an extraordinary transaction. In that event, there would be no occasion for applying the "speculative abuse" test of Kern, and a court would thus have no discretion to refrain from matching the exercise with another transaction in the underlying shares.


146 But see First Lincoln Financial Corp., 1971 Wash. Serv. Bur. Index (available August 23, 1971) (interpretative letter of SEC staff indicating that § 16(b) allows an insider to effect a sale and purchase of his company's shares for tax purposes, provided that in such event any profit he might derive from such transactions inures to and is recoverable by the issuer).

147 See text accompanying note 105 supra.

148 Nevertheless, there has been much controversy over the years with respect to the proper calculation of damages upon exercise of a stock option. The Steinberg case early held that, in matching the acquisition of shares upon exercise of a call option with an insider's sale of the same shares within six months, the measure of damages equals the difference between the sales proceeds and the sum of the exercise price and the value of the option at the date of its "accrual," i.e., the date upon which it became exercisable by the insider. Steinberg v. Sharpe, 85 F. Supp. 32 (S.D.N.Y. 1950).

Because it was believed that this measure of damages unfairly deprived an insider of the increase in the value of his option from the date of acquisition until the date of exercise where those dates were separated by more than six months, see 1960 Yale Comment, supra note 114, at 880-81, the SEC promulgated Rule 16b-6, which limits the profit recoverable from an insider who exercises a stock option acquired more than six months before its exercise to the difference between the proceeds of the sale and the lowest market price of any security of the same class within six months before or after the date of the sale. 17 C.F.R. § 240.16b-6(b) (1973). The Rule limits profit recapture only with respect to "that number of shares covered by the option." See Capital Transamerica Corp., 1973 Wash. Serv. Bur. Index (available September 20, 1973) (interpretative letter by the SEC staff). It was originally suggested that the Commission might have exceeded its authority under § 16(b) in promulgating Rule 16b-6 because the Rule is designed only to limit damages, rather than to exempt a particular transaction from the insider trading recapture provision. See Rattner v. Lehman, 193 F.2d 564, 566 (2d Cir. 1952). However, the constitutionality of Rule 16b-6 has been upheld. Kornfeld v. Eaton, 217 F. Supp. 671 (S.D.N.Y. 1963), aff'd, 327 F.2d 263 (2d Cir. 1964). See 2 Loss supra note 3, at 1081-82; 5 Loss 3046 (Supp. 1969).

Nevertheless, the Steinberg measure of damages still has vitality in certain situations because Rule 16b-6 expressly provides that "[n]othing in this section shall be deemed to enlarge the amount of profit which would inure to the issuer in the absence of this section." 17 C.F.R. § 240.16b-6(b) (1973). Thus, a recent decision made no reference to Rule 16b-6 in holding that an insider was not liable for damages under § 16(b) where the price on the date the option was first exercisable exceeded the price realized on a cash sale of the underlying securities
The import of Kern and Bershad is that an insider’s grant of an option may under some circumstances be deemed a sale of the shares subject to the option under Section 16(b). Hence, the two tests enunciated by the Supreme Court are directly applicable only if there has been a subsequent exercise of the option effecting a disposition of shares which may be related back for Section 16(b) purposes to the date of grant and matched with a second transaction in the underlying securities, within six months of the grant. However, the Supreme Court’s explicit adoption of a flexible philosophy in dealing with “extraordinary” Section 16(b) transactions may suggest that the “speculative abuse” standard may be applicable to insider option transactions related to bids for corporate control even where there has been no exercise of an option. For example, if a prospective acquiring corporation purchased a call option for a large block of the shares of the issuer and then determined to permit the option to lapse, it would be incongruous to characterize the acquisition of the option as a Section 16(b) “purchase” of the underlying shares. Because the insider’s position in the underlying securities of the issuer was not altered by reason of the acquisition of the option, it is difficult to understand how a court could find that the prospective acquirer had the opportunity to abuse its inside position. Furthermore, even if the possibility of speculative abuse could be shown, a plaintiff who sought to match the insider’s transaction in the option with a transaction in the underlying shares would be faced with the difficult question of computing the profit from short-swing transactions in two different securities. Nevertheless, the courts have shown a predilection to squeeze all potential insider profits out of within six months of exercise. Levy v. Seaton, 358 F.Supp. 1 (S.D.N.Y. 1973).

There is presently some uncertainty with respect to which six-month period is relevant under Rule 16b-6 for the purpose of computing damages. Morales v. Walt Disney Products, 361 F.Supp. 1187 (S.D.N.Y. 1973), recently held that the appropriate period for assessing the purchase price of the shares subject to option is the six-month period ending at midnight on the date of the sale. It has been suggested, however, that some courts have utilized an improper “alternative matching” procedure, whereby the court would choose any six-month period which maximized profits. Such period would extend from a date six months before the first transaction to a date six months after the second transaction, thus providing a choice in some cases of eighteen months duration. It has been urged that the Rule only allows, in contrast, for a “single matching” method of looking at the six-month period prior or subsequent to the date of sale. See Palmer, Computing Section 16(b) Profits on Stock Bought Under Option: Applying Rule 16b-6, 25 Bus. Law. 1269 (1970). This view accords with the statement in the Rule that the purchase price of the shares subject to option is “the lowest market price of any security of the same class within six months before or after the date of sale.” 17 C.F.R. § 240.16b-6(b).

Rule 16b-6 has been criticized on the ground that the purchase price it mandates may be as arbitrary as the “date of accrual” test it was designed to replace. See 1960 Yale Comment, supra note 114, at 878-83; Selas v. Voogd, CCH Current Fed. Sec. L. Rep. ¶ 94,374, at 95,294 (E.D. Pa. Sept. 5, 1973) (defendant argued unsuccessfully that Rule 16b-6 should be deemed inapplicable and that the court should undertake “an equitable inquiry into the extent to which [the defendant's exercised] option constituted compensation, and as such would not be considered a profit under § 16(b)'”). It has been proposed that the date of accrual of a stock option ought to be deemed the date of “purchase” where the receipt of an option is followed by exercise and a sale of shares more than six months after accrual; conversely, the date of exercise would be deemed the date of “purchase” where a sale of the underlying securities was followed by receipt of the option. See Hardee, Stock Options and the “Insider Trading” Provisions of the Securities Exchange Act, 63 Harv. L. Rev. 997, 1006 (1952).

It should be noted, however, that the insider's acquisition of an option for a controlling block of shares which is subsequently permitted to lapse might be evidence of the opportunity for speculative abuse with respect to another extraordinary transaction—e.g., the corporate reorganization in Newmark. See text accompanying note 50 supra.
Section 16(b) transactions regardless of the absence of actual financial gain.\textsuperscript{150} Thus, if a court found that the acquisition of an option which is not subsequently exercised presented the opportunity for speculative abuse, it is not inconceivable that, in order to arrive at a measure of recoverable profits, it might assign a price to the shares subject to the option (perhaps the highest price from the time the option became exercisable until its expiration date) and match that price with the price actually realized in the insider’s cash transaction in the underlying securities.

3. The Relevant Period of Inquiry Under Kern

While the Supreme Court did not expressly consider the relevant period for examining the potential for abuse of inside information with respect to the option transaction in Kern, its treatment of the grant and exercise of the Occidental-Tenneco option suggests certain tentative conclusions. The Court examined Occidental’s access to inside information subsequent to the tender offer purchases which made it a statutory insider and prior to the grant of the call option. This approach is consistent with the Gold dissent’s view that the relevant period under Kern is the period between the two matched transactions.\textsuperscript{151}

The appropriate period is more difficult to determine where an insider’s option acquisition (or grant) is the first of two matched transactions. This situation would occur where the only transaction which could be matched with the insider’s acquisition of a call option is a cash sale of the underlying shares which was effected within six months after such acquisition.\textsuperscript{152} In such case, it seems that the insider’s potential to obtain access to inside information after the “extraordinary” transaction—the period urged by the dissent in Gold—should be relevant in characterizing the option agreement as a “purchase” or “sale.” However, the analysis undertaken by the Gold majority should not be disregarded because Kern stressed Occidental’s lack of inside information during the negotiations culminating in the grant of the option. Furthermore, an examination of an insider’s position prior to the option transaction typically should not pose the theoretical difficulties which arise in the reorganization area because there is only one relevant issuer both before and after the option transaction.\textsuperscript{153}

Where the option transaction is the first of the matched transactions, addi-

\textsuperscript{150} For example, Gratz v. Claughton, 187 F.2d 46 (2d Cir. 1951), cert. denied, 341 U.S. 920 (1951), employed the Smolow “lowest purchase price-highest sales price” test, see note 50 supra, to impose liability upon an insider for over $300,000 although the insider had realized a net loss of over $400,000 on all his cash transactions in the issuer’s shares during the relevant six-month period. Munter, Section 16(b) of the Securities Exchange Act of 1934: An Alternative to “Burning Down the Barn in Order to Kill the Rats,” 52 \textit{CORNELL L. Q.} 69, 83 (1966).

\textsuperscript{151} See text accompanying note 67 supra.

\textsuperscript{152} The same situation would occur if (1) the insider’s acquisition of a put could be matched only with a subsequent purchase of the underlying shares, or (2) the insider’s grant of a call could be matched only with a subsequent purchase of the underlying shares, or (3) the insider’s grant of a put could be matched only with a subsequent sale of the underlying shares. However, because the considerations are the same in each case and for the purpose of clarity, this analysis of the appropriate period for assessing the potential for speculative abuse deals solely with the insider-grantee of a call.

\textsuperscript{153} See text accompanying notes 82 to 94 supra.
ional refinements of the appropriate period may be required. If the exercise of the option precedes the second transaction sought to be matched with the option acquisition, the exercise, as well as the grant, would necessarily have occurred within six months of the second transaction. The Kern speculative abuse analysis would be unnecessary in this situation because the plaintiff could match two cash transactions (the exercise of the option with the cash purchase or sale). This is analogous to the sequence of transactions posed in Newmark. If the date of exercise of the option follows the cash purchase or sale, two cash transactions may still be matched so long as the exercise did not occur more than six months after the other cash transaction, regardless of the date of the option's grant. However, if the exercise of the option occurs more than six months after both the option acquisition and an intervening cash purchase or sale, the typical Kern analysis is presented: whether the exercise of the option for cash should be related back to the date of its acquisition. Kern is directly relevant to this question because Tenneco's exercise of the Occidental option occurred more than six months from both the date of grant and the tender offer purchases of the Kern shares, which occurred prior to the grant. The Court noted that the Occidental-Tenneco option was not and, under the terms of the option agreement, could not be exercised until six months from the date of grant. This suggested that Occidental had no potential to indulge in speculative abuse, because whatever inside information it had at the date of grant was presumed, under the statute, to be dissipated by the date of exercise. However, the length of the period between the grant and exercise of the option does not in itself appear to have been determinative, because the Court deemed it necessary to cite other indicia of Occidental's lack of access to inside information. In addition, where the option transaction is followed by a cash purchase or sale, there is an additional period, not available in Kern, during which the possibility of speculative abuse could be found—the period between the option acquisition and the first of the two cash transactions.

Finally, the Bershad test of transfer of ownership of the shares subject to the option seems applicable regardless of the date of exercise. Indeed, the Court would have assessed Section 16(b) liability in Kern, where the exercise occurred more than six months after the grant, if it had found that Occidental had relinquished the emoluments of ownership of the Tenneco shares by virtue of its grant of the call option.

154 411 U.S. at 603. The presence or absence of a six-month period between the acquisition (or grant) of an option and its exercise has figured heavily in proposals for exempting certain insider option transactions from the operation of § 16(b). For example, it has been urged that an insider's issuance of a put or call whose exercisability will not expire for less than six months should not be deemed a "purchase" or "sale" for § 16(b) purposes, because the possibility of exercise outside the statutory six-month period of presumed inside information precludes the possible use of the option by the insider as a mechanism for speculative abuse. See 1972 GEORGIA Note, supra note 119, at 172. In a similar vein, it has been suggested that an insider-grantee's exercise of "long-term" options, e.g., options whose expiration is six months or more from the date of exercise, should not be deemed a § 16(b) "purchase" or "sale" because "the need to exercise the options and hold the option stock in order to realize gain from an anticipated rise during the short-swing period" could not have prompted the insider's exercise. See Laufer, supra note 120, at 248.

155 See text accompanying note 133 supra.
B. Employee Stock Options

The acquisition by insiders of employee stock options pursuant to tax-qualified and non-qualified stock option plans and employee stock purchase plans poses a series of considerations distinct from those presented by the grant and exercise of put and call options in corporate reorganizations. While the grant or acquisition of private puts and calls appears to benefit only the insider who is a prospective acquirer, employee stock option plans serve legitimate, generally acknowledged corporate purposes. Moreover, the treatment of employee stock options under the Exchange Act is governed in part by rules promulgated by the SEC, which have given rise to certain interpretative problems not present in the application of Section 16(b) to put and call options.

1. The Acquisition of Employee Options Under Rule 16b-3

Section 16(b) treatment of the acquisition by insiders of employee stock options pursuant to qualified stock option and employee stock purchase plans qualifying for favorable federal income tax treatment and of restricted stock options (which generally qualify for highly favorable income tax treatment if granted before January 1, 1964) has largely been settled by SEC Rule 16b-3, the prefatory clause of which provides that

156 The three types of plans have many similar features, in part because they must meet many of the same requirements to qualify for favorable Federal tax treatment. See Inr. Rev. Code of 1954 §§ 421-23. Their features relevant for § 16(b) purposes are the following:

Under the plans an employee is granted an option to purchase a specified number of the corporation's shares. The minimum purchase price is determined under specific rules that are different for each type of plan. The exercise price of qualified stock options must be not less than 100% of the fair market value of the shares subject to option at the date of grant, while the exercise price of employee stock purchase plan options must be not less than the lower of 85% of the fair market value of the shares at the date of grant or 85% of the fair market value at the date of exercise. Restricted stock options ordinarily must have an exercise price not less than 85% of the fair market value at the date of grant. However, restricted stock options are of little importance today because they qualify for favorable tax treatment only if granted on or before December 31, 1965, unless such options are granted thereafter pursuant to a binding written contract entered into, or a written plan adopted and approved by the shareholders, before January 1, 1964 which must meet other stringent requirements. Id. § 424(c) (3).

Under the prior law restricted stock option plans did not require shareholder approval to qualify for favorable tax treatment, although shareholder was frequently sought for corporate reasons. In contrast, certain aspects of qualified stock option plans and employee stock purchase plans (e.g., the number of shares available for the plan) must be shareholder-approved. Id. §§ 422(b)(1), 423(b)(2). Stock option and stock purchase plans may also differ in the type of eligible recipients of the options and in the manner and periods of the exercise of the options and payment for the underlying shares. The recipients of qualified or restricted stock options may be limited for tax purposes to officers and other key employees of the corporation. In contrast, the Internal Revenue Code requires that employee stock purchase plan option must be made available to all employees of the corporation, except that the corporation, in its discretion, may exclude certain specified classes of employees, including those who do not work full time or throughout the year and 'officers, persons whose principal duties consist of supervising the work of other employees, or highly compensated employees . . . .' Id. § 423- (b)(4)(D). Moreover, under the terms of a tax-qualified employee stock purchase plan, all employees granted options to purchase shares must have the "same rights and privileges," except that the number of shares allocated under such options may bear a uniform relationship to an employee's total compensation. Id. § 423(b)(5).

Restricted stock options are exercisable for a maximum of ten years from the date of grant. Qualified stock options may be exercisable for a maximum of five years from the date of grant. Employee stock purchase plan options may be exercisable for a maximum of 27 months from the date of grant unless the option price is to be not less than 85% of the fair market value of the shares at the date of exercise, in which case such options may be exercisable for
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[any acquisition of shares of stock (other than stock acquired upon the exercise of an option, warrant or right) pursuant to a stock bonus, profit sharing, retirement, incentive, thrift, savings or similar plan, or any acquisition of a qualified or a restricted stock option pursuant to a qualified or restricted stock option plan, or of a stock option pursuant to an employee stock purchase plan, by a director or officer of the issuer of such stock or stock option shall be exempt from the operation of Section 16(b) of the Act if the plan meets the conditions further specified in the Rule].

Paragraph (d) of the Rule incorporates by reference the Internal Revenue Code's definitions of qualified stock option plan, employee stock purchase plan, and restricted stock option plan (with the exception that the Rule deems an option to be a restricted stock option even if granted after the Code's cut-off date for favorable tax treatment).

However, there are several interpretative problems with respect to the conditions for qualifying for the Rule 16b-3 exemption which are unrelated to the requirements for favorable tax treatment. These interpretative problems have been accentuated by the paucity of consistent administrative interpretations of the Rule's requirements. Two problem areas have arisen under paragraph (a) of Rule 16b-3, which provides that an option acquired by an insider pursuant to a qualified or restricted stock option plan or an employee stock purchase plan may qualify for the exemption provided by the Rule only if the plan "has been approved, directly or indirectly" by a majority of the shareholders of the corporation.

Paragraph (a) does not specify whether the board of directors of a five years. Under any of the plans, the corporation may grant the employees the discretion to elect when to exercise their options until the date of expiration. It should be noted, however, that such discretion may be severely limited by the terms of the option (e.g., the corporation may require the optionee to purchase at least 15% of the shares subject to option within 90 days of the date of grant to prevent the option from lapsing). Under certain employee stock purchase plans, the manner of exercise and payment of the purchase price may be fixed under the plan so that the scope of employee discretion is even further limited. The recipients of options under such plans elect at the date of the offering to have a percentage of their regular compensation, up to a specified maximum, withheld by the corporation. Having elected to participate in the employee stock purchase plan, the employee may have no discretion to determine when the options will be exercised. Instead, the plan may contain a formula which provides that the corporation will utilize the accumulated employee funds to purchase shares in the name of the employee at specified dates, provided that there are funds sufficient to purchase a specified number of whole shares of the corporation's common stock. If the employee chooses a high enough withholding percentage, the corporation might thus purchase shares of stock in his name regularly (perhaps as frequently as monthly). The only discretion remaining in the employee may be terminating completely his participating in the offering (in which case the employee would be permitted to withdraw any uninvested funds accumulated before an investment date), increasing or decreasing his withholding percentage, or, under some plans, reducing the withholding percentage to zero for an indefinite period.

157 17 C.F.R. § 240.16b-3 (1973) (emphasis supplied).
158 See id. § 240.16b-3(d)(2). The SEC staff has indicated that it will express no opinion with respect to whether a plan meets the Internal Revenue Code's definitions of qualified or restricted stock option plan or employee stock purchase plan, see note 156 supra, which are incorporated into Rule 16b-3. Such a determination must be made by the issuer itself. See McDonnell Douglas Corp., 1971 Wash. Serv. Bur. Index (available May 21, 1971) (interpretative letter).
159 Paragraph (a) of Rule 16b-3 provides:

The plan has been approved, directly or indirectly, (1) by the affirmative votes of the holders of a majority of the securities of the issuer present, or represented, and entitled to vote at a meeting duly held in accordance with the applicable laws of the state or other jurisdiction in which the issuer was incorporated, or (2) by the written consent of the holders of a majority of the securities of the issuer entitled to vote: Provided, however, That if such vote or written consent was not solicited sub-
corporation may adopt a qualified or restricted stock option plan or employee stock purchase plan and issue options qualifying for the Rule 16b-3 exemption if shareholder approval is obtained at a subsequent shareholder meeting. It is arguable, in the absence of authority, that the words "has been approved" in paragraph (a) suggest that retroactive approval of the directors' action is precluded. However, it is believed that retroactive shareholder approval should be sufficient to qualify the options for the Rule 16b-3 exemption. Because it is generally impractical for publicly held corporations to solicit shareholder approval more frequently than annually, a requirement of prior shareholder approval would deprive the board of directors of the necessary flexibility to adopt an option plan qualifying under the Rule in a timely fashion if it deems such a plan in the best interests of the corporation (e.g., as an incentive necessary to attract a key executive). Moreover, an analogy may properly be drawn to the carefully circumscribed provisions of the Internal Revenue Code, which are expressly incorporated by reference in Rule 16b-3 and which permit shareholder approval to be obtained up to 12 months after the date of adoption by the board of directors of an option plan for the purpose of qualifying for favorable tax treatment. Furthermore, since the board may provide that options granted pursuant to a plan may not be exercised until shareholder approval has been obtained, it does not appear that the shareholders of the corporation could be harmed through the mere grant of the options under the plan, the effectiveness of which is subject to such shareholder approval.

Another problem arising under Rule 16b-3(a) is that it has not yet been established whether shareholder approval of a qualified or restricted stock option plan or employee stock purchase plan vesting the board of directors with broad rights to amend, modify or terminate the plan might be deemed to violate the substantially in accordance with the rules and regulations, if any, in effect under Section 14(a) of the Act at the time of such vote or written consent, the issuer shall furnish in writing to the holders of record of the securities entitled to vote for the plan substantially the same information concerning the plan which would be required by the rules and regulations in effect under Section 14(a) of the Act at the time such information is furnished, if proxies to be voted with respect to the approval or the amendment of the plan were then being solicited, on or prior to the date of the first annual meeting of security holders held subsequent to the later of (i) the first registration of an equity security under Section 12 of the Act, or (ii) the acquisition of an equity security for which exemption is claimed. Such written information may be furnished by mail to the last known address of the security holders of record within 30 days prior to the date of mailing. Four copies of such written information shall be filed with, or mailed for filing to, the Commission not later than the date on which it is first sent or given to security holders of the issuer. For the purposes of this paragraph, the term "issuer" includes a predecessor corporation if the plan or obligations to participate thereunder were assumed by the issuer in connection with the succession. 17 C.F.R. § 240.16b-3(a) (1973).

160 "No-action" letters issued by the SEC staff have expressly indicated that Rule 16b-3 is applicable to otherwise qualifying plans which have already received shareholder approval at an annual meeting. Harte-Hanks Newspapers, Inc., 1973 Wash. Serv. Bur. Index (available August 13, 1973), or will receive shareholder approval at a subsequent annual meeting prior to the issuance of options. First Pennsylvania Corp., 1973 Wash. Serv. Bur. Index (available March 26, 1973). However, the staff has not yet commented upon the availability of Rule 16b-3 to options granted prior to shareholder approval.

The staff has noted in one interpretative letter that Rule 16b-3 may be available to an otherwise qualifying stock option plan where the shareholders had not expressly approved the plan but had voted in favor of a merger at an annual meeting after receipt of a proxy statement which made it clear that approval of the merger constituted approval of the plan. Southern Natural Gas Co., 1973 Wash. Serv. Bur. Index (available June 11, 1973).

requirement under paragraph (a) that the effective terms of a qualifying plan be approved by the shareholders themselves. Recent SEC "no action" and interpretative letters are inconclusive in this respect. On the one hand, in *Cypress Mines Corp.*, the Commission accorded a Rule 16b-3 exemption to an otherwise qualifying plan which contained a provision vesting broad amendatory discretion in the board of directors. 162 However, in *Westpoint-Pepperell, Inc.*, the Commission denied a Rule 16b-3 exemption merely because the registration statement filed with the plan states that the plan may be terminated, modified or amended by the Company's Board of Directors as well as by its shareholders. On the basis of the facts presented, this division is not able to concur in your opinion that the receipt of the options granted pursuant to the Plan need not be reported.163

Since the position of the Commission on the amendment issue is unclear, it is submitted that the SEC should view stock option plans from the standpoint of the potential for speculative abuse, focusing on the substance of a particular amendment rather than upon the language in the plan setting forth the amendment power. Since it is often impractical for the board of directors to solicit shareholder approval for minor amendments to a plan, shareholders should be deemed to have ratified in advance any modification by the board which they could reasonably have contemplated in approving the plan, including its amendment powers. Whereas the board should not be able to change the significant substantive terms of the plan (e.g., the number of shares, price, or formula of exercisability) without shareholder approval, other revisions which do not distort the purposes of the plan adopted by the shareholders should not be deemed to violate paragraph (a) of the Rule.164

162 The plan provided:

The Company reserves the right, by action of the Board, to amend, suspend or terminate this Plan. No amendment, suspension or termination of this Plan shall have any retroactive effect except when such an effect shall be beneficial to the employees or in the opinion of the Company is necessary or advisable in order to comply with the provisions of Federal or State laws, or any rulings or regulations issued thereunder, pertaining to employee benefit plans and trusts. Notwithstanding the foregoing, no amendment, suspension or termination shall have the effect of providing that the assets held in trust by the Trustee or the income therefrom may be used for or devoted to purposes other than those provided for in this Plan. Upon a complete discontinuance of Company Contributions, contributions of Employee Savings will cease and this Plan will be terminated.


163 *Westpoint-Pepperell, Inc.*, 1972 WASH. SERV. BUR. INDEX (available September 19, 1972). The denial of the exemption is particularly troublesome because counsel had not even raised the amendment issue in its inquiry to the SEC staff.

164 The SEC staff has in fact looked to the substance of a particular amendment of an otherwise qualifying plan, rather than to the scope of amendment power accorded to the board, in the few other interpretative letters relevant to the amendment question. See *Cleveland Elec. Illumination Co.*, 1973 WASH. SERV. BUR. INDEX (available May 7, 1973) (indicating that the staff would recommend no action if the board, without further shareholder action, amended a qualifying profit sharing plan to comply with recent IRS rulings by (1) defining the minimum required employee contribution on the basis of a percentage of compensation rather than a dollar amount and (2) limiting an employee's previously unrestricted right to withdraw contributed funds for educational purposes without forfeiting the employer's contributions, where the basic provisions of the plan were not to be expanded); *Pfizer, Inc.*, 1972 WASH. SERV. BUR. INDEX (available June 29, 1972) (an otherwise qualifying plan would continue to meet Rule 16b-3's requirements upon being amended to include provisions permitting the grant of non-
Other interpretative problems have arisen under paragraph (b) of the Rule, which provides that if "the selection of any director or officer" to whom stock options may be granted or "the determination of the number or maximum number of shares of stock ... which may be covered" by such options granted pursuant to the plan is subject to the discretion of any person, such discretion can generally be exercised only by a committee of "disinterested" persons.165

165 Paragraph (b) of Rule 16b-3 provides:

(b) If the selection of any director or officer of the issuer to whom stock may be allocated or to whom qualified, restricted or employee stock purchase plan stock options may be granted pursuant to the plan, or the determination of the number or maximum number of shares of stock which may be allocated to any such director or officer or which may be covered by qualified, restricted or employee stock purchase plan stock options granted to any such director or officer, is subject to the discretion of any person, then such discretion shall be exercised only as follows:

(i) With respect to the participation of directors—

(ii) by the board of directors of the issuer, a majority of which board and a majority of the directors acting in the matter are disinterested persons; or

(iii) otherwise in accordance with the plan, if the plan (a) specifies the number or maximum number of shares of stock which directors may acquire or which may be subject to qualified, restricted or employee stock purchase plan stock options granted to directors and the terms upon which, and the times at which, or the periods within which, such stock may be acquired or such options may be acquired and exercised; or (b) sets forth, by formula or otherwise, effective and determinable limitations with respect to the foregoing based upon earnings of the issuer, dividends paid, compensation received by participants, option prices, market value of shares, outstanding shares or percentages thereof outstanding from time to time, or similar factors.

(2) With respect to the participation of officers who are not directors—

(i) by the board of directors of the issuer or a committee of three or more directors; or

(ii) by, or only in accordance with the recommendations of, a committee of three or more persons having full authority to act in the matter, all of the members of which committee are disinterested persons.

A committee member is deemed "disinterested" only if he is not at the time such discretion is exercised eligible and has not at any time within one year prior thereto been eligible for selection as a person to whom stock may be allocated or to whom qualified, restricted or employee stock purchase plan stock options may be granted pursuant to the plan or any other plan of the issuer or any of its affiliates entitling the participant therein to acquire stock or qualified, restricted or employee stock purchase plan stock options of the issuer or any of its affiliates.

17 C.F.R. § 240.16b-3(b) (1973).

The SEC staff has been strict in its interpretation of the Rule's requirement that a "disinterested" person may not be (or have been during the previous year) "eligible for selection as a person to whom stock may be allocated or to whom qualified, restricted or employee stock purchase plan options may be granted pursuant to ... any other plan of the issuer or any of its affiliates ..." Id. (emphasis supplied). Thus, where a company had a stock option plan and an employee stock purchase plan otherwise qualifying under Rule 16b-3, the members of the committee appointed to administer the stock option plan were deemed not to be "disinterested" persons because they were eligible to participate in the stock purchase plan. R.B. Jones Corp., 1972 WASH. SERV. BUR. INDEX (available August 25, 1972). However, because the definition of "disinterested" person refers only to eligibility under the tax-qualified employee compensation plans (i.e., qualified or restricted stock option plans and employee stock purchase plans) as defined in the Internal Revenue Code, it appears that a person will be deemed "disinterested" if he is (or has been during the previous year) eligible to receive stock or options only under non-tax-qualified plans (e.g., an employee stock option plan in which the purchase price of the underlying shares is fixed below 85% of the market price at the date of grant).

The proviso in subparagraph (b) (1)(iii) that, in the case only of directors, the discretion is deemed to be exercised in accordance with paragraph (b)'s requirements if the plan itself either specifies the number or maximum number of shares which the director may acquire...
Certain plans are administered on a day-to-day basis by either an officer or director designated as an administrator or by an independent trustee (e.g., a bank or trust company). While the Rule does not appear to preclude an administrator from being interested in the plan, the language of paragraph (b) fails to establish whether certain powers may be exercised by the administrator without the approval of the disinterested committee. For example, it is currently unclear whether paragraph (b) would be violated if an administrator were granted the power under the plan to include or exclude directors or officers as a class without the prior approval of a disinterested committee. It is arguable that the words “the selection” in paragraph (b) refer only to the inclusion of directors and officers, so that an administrator’s exclusion of all insiders would not have to be approved by the committee. But it may be urged that even a power to include insiders as a class could be exercised without committee approval on the ground that the language “any director or officer” limits paragraph (b)’s scope to the selection of individual directors or officers.

Moreover, it is conceivable that the administrator’s power under certain plans to “construe the rights of all employees under each offering” and to “determine the total number of shares subject to each offering” might be interpreted as a form of discretion to determine “the number or maximum number of shares of stock . . . which may be covered” by options granted to officers and directors, which may not be exercised under paragraph (b) unless approved by the disinterested committee. However, it is submitted that paragraph (b) should not be deemed to have been violated unless the administrator has the additional power to modify the allocation among the various individual officer or director insiders after the total number of shares in the offering is established.

Paragraph (b) also does not state whether a qualifying plan must explicitly restrict the power of the board of directors to amend the plan to eliminate the committee of disinterested persons or to authorize the appointment to the committee of a person who is not a “disinterested” person within the meaning of the Rule. Nevertheless, the Commission has apparently taken the position that paragraph (b) will not be violated unless the board affirmatively amends the plan pursuant to the plan and the time periods of exercise or sets forth “effective and determinable limitations” establishing such a maximum number of shares and the periods of exercise may be of little benefit to issuers as many plans make officers eligible as well as directors.

166 The SEC staff has indicated that a plan will not be deemed to vest employees with discretion violating Rule 16b-3(b) if they are given the power to determine whether 2%, 4% or 6% of compensation will be withheld and invested in the company’s common shares, even where such a determination fixes the size of the employer’s matching contribution. Amerada Hess Corp., 1972 Wash. Serv. Bur. Index (available May 1, 1972) (employee savings and stock bonus plan). See also Fillsbury, Madison & Sutro, 1973 Wash. Serv. Bur. Index (available July 30, 1973) (SEC staff reaffirming its view in Amerada Hess Corp. that Rule 16b-3(b)(2) was not intended to destroy the availability of the Rule 16b-3 exemption to plans having provisions allowing participating employees to make determinations of the type specified therein).

167 There is an additional ground for finding that an administrative power to include insiders in an employee stock purchase plan could not lead to speculative abuse. Since participation in an employee stock purchase plan must typically be open to all full-time employees to qualify for favorable tax treatment, see note 156 supra, the inclusion of insiders would at best put them on a parity with other employees.
expressly to allow persons interested therein to serve on the committee.\textsuperscript{168}

Finally, the Commission has not clarified to date whether the phrase "in accordance with the recommendation of a committee of three or more [disinterested] persons" in paragraph (b) permits majority action or requires unanimous action by the committee where the committee consists of the minimum three persons. It is submitted that because the Rule speaks in terms of the recommendation of the \textit{committee} as a governing body, rather than the unanimous recommendation of its three individual members, approval by a committee majority of the exercise of administrative discretion with respect to officers and directors should satisfy paragraph (b).

The requirement of paragraph (c) of Rule 16b-3 that any qualified or restricted stock option plan or employee stock purchase plan must effectively limit the aggregate dollar amount or the aggregate number of shares of stock which may be allocated or which may be subject to options granted to all participants pursuant to the plan gives rise to an additional interpretative problem under the Rule. Because paragraph (c) specifically provides that such limitations "may be established on an annual basis, or for the duration of the plan, whether or not the plan has a fixed termination date,"\textsuperscript{169} it is possible that a plan may be required explicitly to provide that the shareholders may not amend the plan more frequently than annually to vary the aggregate dollar amount or the aggregate number of shares of stock to qualify for the Rule's exemption. In view of the fact that the shareholders could avoid that requirement simply by creating a new plan, the presence of such a power to amend probably should not be deemed to exceed the requirements of paragraph (c) if the plan otherwise limits the aggregate dollar amount and the aggregate number of shares of stock which may be allocated to participants.

2. Acquisition of Non-exempt Employee Options

The Rule 16b-3 exemption may be unavailable for an insider's acquisition

\textsuperscript{168} See Norton Simon, Inc., 1971 \textsc{Wash. Serv. Bur. Index} (available April 16, 1971). The SEC staff reply noted:

\begin{quote}

The plan does not limit participation to officers who are not directors. The administrative committee is to consist of directors. Should officers who are also directors be selected to participate, the plan would not be exempt. Furthermore, the plan may be amended or modified at any time by the Board of Directors. Should those provisions of the plan which govern membership on the administrative committee be amended to permit interested persons to serve thereon any exemption theretofore in existence would be defeated.
\end{quote}

\textsuperscript{169} Paragraph (c) of Rule 16b-3 provides:

\begin{quote}
As to each participant or as to all participants the plan effectively limits the aggregate dollar amount or the aggregate number of shares of stock which may be allocated, or which may be subject to qualified, restricted, or employee stock purchase plan stock options granted, pursuant to the plan. The limitations may be established on an annual basis, or for the duration of the plan, whether or not the plan has a fixed termination date; and may be determined either by fixed or maximum dollar amounts or fixed or maximum numbers of shares or by formulas based upon earnings of the issuer, dividends paid, compensation received by participants, option prices, market value of shares, outstanding shares or percentages thereof outstanding from time to time, or similar factors which will result in an effective and determinable limitation. Such limitations may be subject to any provisions for adjustment of the plan or of stock allocable or options outstanding thereunder to prevent dilution or enlargement of rights.
\end{quote}

\textsuperscript{17} C.F.R. \textsection 240.16b-3(c) (1973).
of employee stock options under tax qualified stock option plans and stock purchase plans (meeting the Rule's definitional requirements) because such plans may fail to meet one of the Rule's other conditions. In addition, issuers have frequently elected to adopt non-qualified stock option plans ineligible for favorable tax treatment, which are thus ineligible for the Rule 16b-3 exemption because they fail to meet the Rule's definitional requirements.\textsuperscript{170} Where an issuer adopts a plan allowing for the extension of both qualified and non-qualified stock options (under which, for tax reasons, any individual may be granted either qualified or non-qualified options, but not both), it appears that those options which are tax-qualified will also qualify for the Rule 16b-3 exemption so long as the plan meets the other requirements of the Rule.\textsuperscript{171}

The possibility of matching an insider's acquisition of a stock option granted pursuant to a qualified or restricted stock option plan or employee stock purchase plan with a subsequent sale of that option itself is precluded because such options are made non-transferable (except by will or the laws of descent) in order to qualify for favorable tax treatment.\textsuperscript{172} In contrast, it is well established that an insider's sale of transferable options acquired pursuant to a non-qualified stock option plan, or of other transferable warrants or stock subscription rights, will ordinarily give rise to Section 16(b) liability in the amount of the difference between the sale proceeds and the value of the options on the date of their acquisition, although the acquisition value may be difficult to determine if the options are not actively traded.\textsuperscript{173}

\textsuperscript{170} The mere fact that the SEC has specifically exempted the acquisition of certain employee options from the operation of § 16(b) through Rule 16b-3 should not raise an inference that the acquisition of non-exempt options is necessarily a "purchase." As noted earlier, the SEC has no enforcement authority under § 16(b). See note 21 supra.

\textsuperscript{171} See Cypress Mines Corp., 1973 WASH. SENV. BUR. INDEX (available February 19, 1973) (interpretative letter by the SEC staff indicating that all options granted under a plan are restricted stock options except those granted to the company's controlling shareholder, the fact that the controlling shareholder is not to receive the restricted stock options would not in itself preclude the availability of Rules 16a-6 and 16b-3 as to other optionees). See also Pfizer, Inc., 1972 WASH. SERV. BUR. INDEX (available June 29, 1972) (staff interpretative letter indicating that a stock option plan which previously satisfied the requirements of Rule 16b-3 continues to meet those requirements upon being amended to include provisions permitting the grant of non-qualified as well as qualified stock options).

\textsuperscript{172} See INT. REV. CODE OF 1954 § 421-24. Nevertheless, there is a potential for matching an insider's acquisition of a non-transferable option with his own grant or sale within six months of a transferable call on the same securities of the corporation. It is hard to distinguish such a transaction from ordinary insider trading in options. See text accompanying note 117 infra.

\textsuperscript{173} In Truncale v. Blumberg, 88 F. Supp. 677 (S.D.N.Y. 1950), where the plaintiff succeeding in matching an insider's acquisition of transferable incentive warrants with his subsequent sale of a portion of the warrants, the market price was readily obtainable. Judge Rifkind rejected the plaintiff's argument that the cost of the warrants was zero and that the profit recoverable from the insider should be the total price received by him upon disposition. He held, rather, that the purchase price would equal the market value of the warrants at the date of acquisition. (It should be noted that this is not necessarily the date of "accrual" utilized by the Steinberg court to determine the purchase price of shares acquired upon exercise of a stock option. See note 146 supra). Professor Loss approved of the Truncale test, noting that "in the absence of an active market for the warrants on the date of their acquisition, the solution which most readily suggests itself is simply to take the difference between the market value at the stock, called 'exercise price,' and the exercise price." 2 Loss, supra note 3, at 1078.

However, the acquisition price of stock options is much more difficult to determine where the options are not exercisable immediately upon acquisition. Loss suggests that in order to maximize the profit recoverable from an insider "it is conceivable that under the Smolowe approach the courts will say that a 'purchase' occurs on each of several dates and will pick whatever date maximizes the 'profit' in the particular case." Id. at 1079.
A problem confronting insiders is the potential for matching the acquisition of stock options failing to qualify for the Rule 16b-3 exemption with the insider’s sale of the underlying securities within six months of such acquisition. If the insider’s exercise of the employee option occurs within six months of the sale, there would appear to be no difficulty in matching two cash transactions under Section 16(b). However, where only the date of grant, and not the date of exercise, of the option falls within the relevant six-month period, Kern appears to dictate the application of the same two tests utilized in analyzing option transactions in corporate takeovers: whether the insider’s acquisition of the employee stock option was in effect a purchase of the shares subject to option and whether the transaction could have lent itself to speculative abuse.

It appears that the acquisition of employee options could, under some circumstances, amount to a purchase of the underlying shares in economic terms. A non-qualified stock option, warrant, or other stock purchase right could provide for such a low or nominal exercise price that a court would be justified in finding that the underlying shares were in effect transferred to the optionee on the date of grant. This possibility is precluded for tax-approved plans, however, because the requirements for favorable tax treatment prevent the exercise price of qualified stock options and of employee stock purchase plan options from being established at less than 100% or 85%, respectively, of the market price.

However, other factors suggest that the ownership of shares acquired pursuant even to non-tax-qualified plans may not be transferred until the date of exercise of the employee options. Employee stock option and purchase plans typically provide that an option holder has none of the rights incident to ownership of the shares until the options are exercised. In addition, the fact that the employee option holder typically pays no consideration for his options lessens the possibility that it is economically unlikely for the insider not to exercise his option.


175 See note 189 infra.

176 The tests of Kern are not directly applicable if an insider either had not yet exercised the employee options or had permitted the options to lapse without exercise. See text accompanying note 149 supra.

177 See note 156 supra.

178 The SEC staff has not been confronted to date with the question of whether an insider’s acquisition of non-exempt employee stock options should be deemed a “purchase” of the shares underlying the option. In Xerox Corp., 1973 Wash. Serv. Bus. Index (available May 7, 1973), the issuer’s counsel argued that an insider’s acquisition of “stock appreciation rights” in connection with a qualified stock option plan meeting the requirements for exemption under Rule 16b-3 should not be deemed a “purchase” for the purposes of § 16(b). Under the terms of the qualified stock option plan, if an employee exercised a stock appreciation right with respect to 100 shares under a related option having an exercise price of $100 per share at a time when the fair market value of the share was $200, he would be entitled to receive, without payment to the corporation, 50 shares of its common stock. To the extent that the employee exercised the stock appreciation right, the number of shares covered by the related option would be proportionately reduced. Because the SEC staff took the view that a stock appreciation right is not sufficiently similar to a “stock bonus” to bring it within the Rule 16b-3 exemption, see text accompanying note 157 supra, its reply stated that “it is the view of this Division that the acquisition of a stock appreciation right in the manner specified in your letter is a ‘purchase’ of an ‘equity security’ within the meaning and intent of Section 16b of the Securities Exchange Act.” Curiously, however, the staff went on to note that “[w]e express no opinion as to the applicability of Section 16(b) to such acquisition.” Very recently, in Mobile Oil Corp., CCH Current Fed. Sec. L. Rep. No. 526, 9
It appears that a court will be more inclined to find that an insider's acquisition of an employee option could have lent itself to "speculative abuse" than it will in the case of the acquisition of an option in a corporate takeover context, because the recipient of the employee option, as a member of the issuer's management, may be unable to rebut the presumption of access to inside information. However, other factors peculiar to employee stock option plans mitigate against the finding of the possibility for speculative abuse. The motivation for the corporation's grant and the insider's acquisition of the employee options—increasing the insider's stake in and incentive on behalf of the corporation—does not appear to "smack of" speculative abuse. Nevertheless, a distinction must be drawn between employee stock purchase plan options and options received pursuant to qualified and non-qualified stock option plans. While the recipients of employee stock purchase plan options have certain discretion with respect to their participation in the plan, many do not have the power to time their exercise of the options to maximize the spread between the exercise price and the market price, because the date of exercise may be determined by a fixed formula established under the plan on the date of grant. In contrast, the recipients of other employee stock options typically have the discretion to elect when their options will be exercised. Such a power to maximize profit could be deemed to present the potential for speculative abuse which the statute was designed to prohibit.

3. Rule 16a-6 Reporting Requirements

Beyond the question of whether or not an insider's acquisition of employee stock options is deemed a "purchase" for the purposes of Section 16(b), there is also some ambiguity with respect to the insider's reporting obligations under

February 7, 1974, the staff reversed its position and took the view that the acquisition of stock appreciation rights is exempt under Rule 16b-3 when such rights are granted in tandem under a single plan with employee stock options which qualify for the Rule's exemption. However, the staff did not indicate whether it had reconsidered its view expressed in Xerox that the acquisition of non-exempt stock appreciation rights is a "purchase for the purposes of § 16(b)."

The danger is that if the SEC staff continues to take the position that the acquisition of a non-exempt stock acquisition right is a "purchase" for the purpose of § 16(b), it may also take the position that the acquisition of a stock option under a tax-qualified plan failing to meet the requirements of Rule 16b-3, or under any non-tax qualified plan, may also be deemed a "purchase." However, in view of the reversal in Mobile Oil and the fact that the staff's response in Xerox was drafted prior to the Kern decision, the force of this analogy is unclear. It is possible that the acquisition of stock appreciation rights would be deemed a "purchase" under Kern, and might be distinguishable from the acquisition of non-exempt employee stock options, on the ground that stock appreciation rights practically transfer ownership of the underlying shares to the holder because shares are automatically transferred to the account of the recipient without any investment on his part if the market value of the shares rises.

179 See text accompanying note 139 supra.
180 See Rubin & Feldman, supra note 117, at 487.
181 Only one decision has considered the question whether an insider's acquisition of employee options should be deemed a "purchase" under § 16(b). In Truncate v. Blumberg, 80 F. Supp. 387, 392 (S.D.N.Y. 1948), which was not cited by the Supreme Court in Kern, Judge Medina held that the disposition by way of gift of stock warrants acquired by a corporate officer did not involve a "sale" within the meaning of § 16(b). He went on to state in dictum that the original issuance of the incentive warrants to the officer pursuant to an employment contract did involve a "purchase" of the warrants under § 16(b).

Truncate appears to be of limited precedential value after Kern. As noted earlier, it appears that Truncate would be followed in any case in which an insider has acquired transferable employee options or warrants and resold them for cash, because such a transaction is
Section 16(a) of the Exchange Act.\footnote{181.1} The proper reporting of the grant and acquisition of options and other stock rights is now treated quite extensively in SEC Rule 16a-6, paragraph (a) of which provides that

[the granting, acquisition or disposition of any presently exercisable put, call, option or other right or obligation to buy securities from, or sell securities to, another person, or any expiration or cancellation thereof, shall be deemed to effect such a change in the beneficial ownership of the securities to which

indistinguishable from ordinary insider trading in options. Although the insider typically would not pay cash for the options, the corporation's expectation of his continued employment appears to be an adequate substitute for cash. However, Judge Medina's dictum should not be taken to stand for the broad proposition that any acquisition by an officer or director of stock options or warrants from a corporation involves a purchase within the meaning of § 16(b). In contrast, it appears that Kern effectively overruled Truncale's rather wooden approach to the "purchase" or "sale" issue where an "extraordinary" transaction is presented (e.g., where the insider's acquisition of the employee options may be matched only with a corresponding transaction in the underlying shares).

There is authority which affirmatively suggests that an insider's receipt of stock options pursuant to an employee stock purchase plan is not a "purchase" for § 16(b) purposes. In the only other case clearly dealing with an insider's receipt of stock subscription rights, Shaw v. Dreyfus, 172 F.2d 140 (2d Cir.), cert. denied, 337 U.S. 907 (1949), the Second Circuit distinguished Truncale in holding that an insider's receipt of subscription rights on the same basis as their receipt by other shareholders does not involve a "purchase" of the rights within the meaning of § 16(b). ("The holding of the Shaw case has frequently been cited as standing for the proposition that the receipt of a pro-rata stock dividend by an insider is not a § 16(b) "purchase."\footnote{181.1} The reasoning of the Shaw majority was that where an insider is able to obtain a stock dividend only upon the same terms and conditions as other shareholders, there is no opportunity for the kind of manipulation and use of inside information that § 16(b) was designed to eliminate. The Shaw decision thus appears to have employed the same type of reasoning implicit in the speculative abuse test adopted by Kern. The majority's reasoning was vigorously attacked in a dissent by Judge Clark, who believed that insiders could use their advance knowledge of an impending grant of a stock dividend either to retain their own shares or to acquire additional shares on a basis not available to other shareholders.

The reasoning of the Shaw majority seems applicable and Judge Clark's objection inapplicable to employee stock purchase plans. Just as shareholder officers and directors of the issuer acquire no better rights than other shareholders through a pro-rata distribution of stock subscription rights, insider officers and directors eligible to participate in an employee stock purchase plan by definition may receive no more favorable treatment than other employees of the corporation. \textit{See} note 156 supra.\footnote{181.1}


Every person who is directly or indirectly the beneficial owner of more than 10 per centum of any class of any equity security (other than an exempted security) which is registered pursuant to section 12 of this title, or who is a director or an officer of the issuer of such security, shall file, at the time of the registration of such security on a national securities exchange or by the effective date of a registration statement filed pursuant to section 12(g) of this title, or within ten days after he becomes such beneficial owner, director, or officer, a statement with the Commission (and, if such security is registered on a national securities exchange, also with the exchange) of the amount of all equity securities of such issuer of which he is the beneficial owner, and within ten days after the close of each calendar month thereafter, if there has been a change in such ownership during such month, shall file with the Commission (and if such security is registered on a national securities exchange, shall also file with the exchange) a statement indicating his ownership at the close of the calendar month and such changes in his ownership as have occurred during such calendar month.

Initial statements of beneficial ownership of equity securities required by § 16(a) must be filed on SEC Form 3. Statements of changes in such beneficial ownership required by § 16(a) must be filed on Form 4. SEC Rule 16a-1, 17 C.F.R. § 240.16a-1 (1973). The instructions provided for the completion of Form 4 require the reporting of every transaction effected by a corporate insider "even though acquisitions and dispositions during the month are equal, or the change involves only the nature of ownership, such as a change from indirect ownership through a trust or corporation to direct ownership by the reporting person. SEC Sec. Ex. Act Rel. No. 9500 (1972).
the right or obligation relates as to require the filing of a statement [on SEC Form 3 or Form 4]...\textsuperscript{182}

It appears that an insider need not file a report with respect to his acquisition of qualified or restricted stock options or employee stock purchase plan options pursuant to a plan which meets the conditions specified in Rule 16b-3, because paragraph (c) of Rule 16a-6 specifically exempts non-transferable options qualifying for the Rule 16b-3 exemption from the reporting requirements under Section 16(a).\textsuperscript{183}

However, an insider’s obligation to file a report upon the acquisition of employee stock options pursuant to a plan \textit{failing} to qualify for the Rule 16b-3 exemption appears to rest on whether the options are as yet “presently exercisable” within the meaning of paragraph (a) of Rule 16a-6. The SEC staff has affirmed on several occasions that stock options received by insiders pursuant to a restricted or qualified stock option plan failing to meet the requirements of Rule 16b-3 must be reported under Rule 16a-6 immediately upon receipt because such options typically are “presently exercisable.”\textsuperscript{184} Nevertheless, it is arguable that an insider’s receipt of an option interest in an employee stock purchase plan should not be reportable under Rule 16a-6 on the ground that it is not “presently exercisable” since the option may not be exercised and shares of stock may not be purchased until the end of an option period in which the employee has accumulated sufficient funds to purchase a specified number of whole shares. Under this view, employee stock purchase plan options would not become “presently exercisable” before the last day on which the employee has the opportunity to withdraw his funds, typically the last business day of the investment period.\textsuperscript{185} Since the options would also be exercised on that day, it seems

\textsuperscript{182} 17 C.F.R. § 240.16a-6(a) (1973) (emphasis supplied). Under Rule 16a-6, “both the grantor and the holder of a put, call, option or other right or obligation to buy or sell securities are deemed to be beneficial owners of the securities subject to such right or obligation.” SEC Sec. Ex. Act Rel. No. 9439 (1972).

\textsuperscript{183} 17 C.F.R. § 240.16a-6(c) (1973).

\textsuperscript{184} See Faberge, Inc., 1972 WASH. SERV. BUR. INDEX (available October 26, 1972) (plan failed to meet Rule 16b-3's requirements because one or more of the three members of the plan's administrative committee was not a “distinterested” person); R.B. Jones Corp., 1972 WASH. SERV. BUR. INDEX (available August 25, 1972) (plan failed to qualify under Rule 16b-3 because the members of the administrative committee were eligible to participate in a second stock purchase plan of the issuer); Ralston Purina Co., 1971 WASH. SERV. BUR. INDEX (available October 26, 1971) (plan failed to qualify under Rule 16b-3 because the options granted pursuant thereto were neither qualified nor restricted stock options as defined in the Internal Revenue Code).

\textsuperscript{185} There appears to be some administrative support for this position by analogy to a recent SEC no-action letter, Automatic Dividend Reinvestment Service, 1973 WASH. SERV. BUR. INDEX (available February 12, 1973). Pursuant to the terms of the Service, the First National City Bank holds shares of stock on behalf of employees of various participating corporations. Approximately two days after quarter-annual dividends are received by the bank, the bank commences to invest the dividends in additional shares purchased in the market. The purchase of the shares is not completed until approximately 9 days after the initial receipt of the dividend. After the acquisition is completed, the bank adjusts its records to reflect the interest of all participating shareholders, and approximately 18 days after the initial receipt of the dividend, it mails confirmations to such persons setting forth the number of additional shares they have acquired and the price per share.

In response to the inquiry of the bank as to when an officer or director “acquires” stock purchased through the Service for the purposes of § 16(b), the SEC staff noted:
reasonable that only the acquisition of the underlying shares upon exercise of the employee stock purchase plan options should have to be reported in a Form 3 Report or a Form 4 Report filed for the period of exercise.\(^{185}\)

4. Exercise of Employee Stock Options

Rule 16b-3 does not appear to exempt an insider’s acquisition of shares of stock upon exercise of qualified or restricted stock options or employee stock purchase plan options from the operation of Section 16(b), because the prefatory clause to the Rule exempts stock acquired by a corporation’s officers or directors only if it is issued pursuant to a “stock bonus, profit sharing, retirement, incentive, thrift, savings or similar plan” meeting the Rule’s conditions.\(^{187}\) In contrast, the prefatory clause explicitly exempts only an insider’s acquisition of

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With respect to your question of when a reporting person is deemed to acquire a beneficial interest through the Service, we feel that date should correspond to the last day on which such participant is able to withdraw any uninvested cash held for his account, and instead is entitled only to a distribution of whole shares which have been or will be purchased for his account. We would not take any action if such acquisitions are reported on a Form 4 which is filed within 10 days after the close of the calendar month in which such participant receives a notification of securities purchased for his account.

While an insider participating in the Automatic Dividend Reinvestment Service is not explicitly granted an option to purchase additional shares of stock, it appears that his ability to withdraw the dividend credited to his account by the bank from the day it is received by the bank until the day on which it is invested in additional shares of stock economically leaves him with a type of right to purchase additional shares of stock. Thus the receipt by the bank of the dividend probably should be deemed the acquisition by the insider of an “option or other right” to buy securities from an issuer within the meaning of Rule 16a-6. But since such “option or other right” is not acquired pursuant to a plan meeting the requirements of Rule 16b-3, the timing of its reportability under Rule 16a-6 should not be different from that of an employee’s acquisition of an option interest pursuant to an employee stock purchase plan which also fails to meet Rule 16b-3’s requirements.

There is thus an additional ground for finding that an insider’s acquisition of employee stock purchase plan options should not be deemed a “purchase.” Rule 16a-10 provides that any transaction which has been or shall be exempted by the Commission from the requirements of Section 16(a) shall, in so far as it is otherwise subject to the provisions of Section 16(b), be likewise exempted from Section 16(b).

186 There is thus an additional ground for finding that an insider’s acquisition of employee stock purchase plan options should not be deemed a “purchase.” Rule 16a-10 provides that any transaction which has been or shall be exempted by the Commission from the requirements of Section 16(a) shall, in so far as it is otherwise subject to the provisions of Section 16(b), be likewise exempted from Section 16(b).

187 See, e.g., Potlatch Corp., CCH CURRENT FED. SEC. L. REP. ¶ 79,613 (available October 24, 1973) (interpretative letter of SEC staff indicating that the acquisition of the company’s shares by officers and directors pursuant to its salaried employees’ savings investment plan appears to be exempted by Rule 16b-3); American Express Co., 1973 WASH. SERV. BUR. INDEX (available April 25, 1973) (interpretative letter indicating that the acquisition of the company’s shares by officers and directors pursuant to its incentive savings plan appears to be exempted by Rule 16b-3); First Pennsylvania Corp., 1973 WASH. SERV. BUR. INDEX (available March 26, 1973) (interpretative letter indicating that the profit-sharing benefits received under the company’s deferred compensation plans are within the protection of Rule 16b-3). Such plans are distinguishable from employee stock option and stock purchase plans because (1) employees may acquire common shares of the company without making any cash investment, and (2) such shares may be acquired directly without the extension of employee stock options.

It should be noted, however, that shares acquired pursuant to a “stock bonus, profit sharing, retirement, incentive, thrift, savings or similar plan” must be reported pursuant to § 16(a) despite the fact that their acquisition is specifically exempted from the operation of § 16(b) by Rule 16b-3. See National Can Corp., 1972 WASH. SERV. BUR. INDEX (available May 25, 1972) (interpretative letter indicating that beneficial interests acquired by insiders in the company’s profit sharing trust must be reported under § 16(a)).
qualified or restricted stock options or employee stock purchase plan options themselves if the plan meets the Rule's conditions. While Rule 16b-3 does not explicitly state that shares received upon the exercise of an exempted option are within the operation of Section 16(b), this may be inferred from the parenthetical phrase in the prefatory clause which denies the exemption to the acquisition by officers and directors of shares of stock pursuant to even a "stock bonus, profit sharing, retirement, incentive, thrift, savings or similar plan," in which the acquisition of shares is ordinarily exempt, where such stock is acquired "upon exercise of an option, warrant or right . . . ." It does not appear that the SEC intended to give the acquisition of shares of stock pursuant to the exercise of qualified stock options or employee stock purchase plan options more favorable treatment.

Because employee stock options are already subject to extensive administrative regulation, the SEC would appear to have a special interest in resolving at least the more significant interpretative problems which have arisen under Rules 16b-3 and 16a-6. While such clarification would probably be best effected through a series of minor amendments to the rules governing options, the SEC might also consider the desirability of publishing an interpretative release, which could also deal with other option problems within the jurisdiction of the Commission (e.g., the reporting under Rule 16a-6 of non-transferable puts and calls in the reorganization context).

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188 See text accompanying note 157 supra. Paragraph (d)(3) of Rule 16b-3 provides that the phrase "exercise of an option, warrant or right" does not include
(i) the making of any election to receive under any plan compensation in the form of stock or credits thereof provided that such election is made either prior to the making of the award or prior to the fulfillment of all conditions to the receipt of the compensation and, provided further, that such election is irrevocable until at least 6 months after termination of employment;
(ii) the subsequent crediting of such stock;
(iii) the making of any election as to the time for delivery of such stock after termination of employment, provided that such election is made at least 6 months prior to any such delivery;
(iv) the fulfillment of any condition to the absolute right to receive such stock; or
(v) the acceptance of certificates for shares of such stock.


189 See Keller Industries, Inc. v. Walden, 462 F.2d 388, 390 (5th Cir. 1972) (holding that the acquisition of shares upon exercise of an option, even though qualified or restricted under the tax laws, is not exempted from the operation of § 16(b) by Rule 16b-3).

Once an insider has exercised stock options acquired from his corporation, it appears there is little the corporation may do to protect the insider from whatever liability he would otherwise incur under § 16(b). For example, Volk v. Zlotoff, 285 F. Supp. 650, 657 (S.D.N.Y. 1968), held that an issuer may not attempt "to protect its insiders from [§ 16(b)] liability by rescinding the exercise of the stock options." Moreover, a state trial court has held, citing Volk, that a corporation may not provide an insider with a cash bonus to offset § 16(b) liability incurred through a cash purchase and sale of the corporation's shares. See Selon v. Hickman, [1972-1973 Transfer Binder] CCH Fed. Sec. L Rep. ¶ 93,557 (N.Y. Sup. Ct. 1972). Nevertheless, issuers might at least be able to provide insiders of the corporation with the damage limitation afforded by Rule 16b-6 if the first possible exercise date for qualified stock options or employee stock purchase plan options is made more than six months after the date of grant. See note 148 supra. See also Lewis v. Dwyer, BNA Sec. Rep. & L. Rep. No. 227, at A-5 (D. Mass. 1972) (where an insider's check mailed to the corporation pursuant to a stock option agreement during the relevant six-month period did not arrive until the six months had elapsed, the insider was held not to be liable for short-swing profits under § 16(b)).
IV. Conclusion

The scope and meaning of Section 16(b) have been expanded in recent years to encompass an increasingly broad variety of corporate transactions. In meeting the interpretative problems, the courts have demonstrated a commendable reluctance to impose liability unless it is warranted in light of the statutory purpose. Nevertheless, many significant areas remain which require further interpretation, and it is often difficult, therefore, to forecast with certainty the results in a particular factual setting. Experienced counsel will ordinarily furnish conservative advice to clients who may be statutory insiders, which, in itself, constitutes a deterrent to insider trading. Such advice may now be rendered within a legal framework which permits the evaluation of unusual fact situations.

Although Section 16(b) has come of age, its development is far from complete. There is considerable debate concerning the continued importance of Section 16(b) as a result of the expanding application of other anti-fraud remedies under the federal securities statutes. Any sweeping change in the federal securities laws will presumably deal with this problem, and if the equivalent of Section 16(b) is retained, many of the current interpretative problems are likely to be resolved by such legislation. In addition, in both the

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191 The American Law Institute has retained a deterrent against insider trading in its Proposed Federal Securities Code, ALI Fed. Sec. Code (Tent. Draft No. 2, 1973). Section 1413(a), the basic liability provision, is the analogue of § 16(b). It maintains the present purchase-sale concept by providing that "any profit realized by [an insider] from a purchase and sale (or sale and purchase), within a period of less than six months, of securities of a class subject to [the registration requirement of the Code] inures to and is recoverable by the issuer..." Id. § 1413(a).

The Code attempts to clarify and rationalize the treatment of reorganization transactions under § 1413(a). The term "sale" is defined to include "the issuance of a security pursuant to a merger, consolidation, recapitalization, or transfer of assets for securities." Id. § 293(f). The term "purchase" is the correlative of the term "sale." Id. § 283. It thus appears that typical reorganization transactions would be included within the Code's definitions of "purchase" and "sale" for the purposes of the basic liability provision. However, paragraph (h) of § 1413 makes the section inapplicable to the acquisition or disposition of securities pursuant to a merger, consolidation, recapitalization or transfer of assets for securities (including an incidental cash sale pursuant to dissenters' appraisal rights), or an exchange pursuant to an offer made on the same terms to all holders of securities of a particular class, if the defendant proves that he did not use information obtained by reason of his relationship to an involved issuer. Id. § 1413(h).

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Since paragraph (h) deals only with the possibility that the reorganization itself might not be deemed a "purchase" or "sale," an additional subsection of § 1413 was required to deal with the treatment of an insider's cash purchase of the securities of the acquired company, an intervening reorganization, and his cash sale of the securities of the acquiring corporation, all within six months. Paragraph (g) provides that if both issuers are registrants when the securities specified therein have more than one issuer, § 1413 applies with respect to (1) a purchase (or sale) of a security that disappears as a result of a merger, consolidation, recapitalization or transfer of assets for securities, and (2) a sale (or purchase) of a security receivable or received pursuant to the consummation of a merger, consolidation, recapitalization or transfer of assets for securities, unless the defendant proves that under the circumstances his purchase and sale or sale and purchase could not have lent themselves to speculative abuse. Id. § 1413(g). A "registrant" is an issuer that has an effective registration statement [filed with
reorganization and option areas, the SEC has the power to adopt exemptive rules, or to clarify existing rules, so as to establish greater certainty in the application of Section 16(b) and thus avoid the imposition of liability as a result of inadvertent short-swing transactions.192