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under the 1934 Act's general anti-fraud section, might prompt it to re-evaluate the purchaser-seller rule in view of the recognized injury to issuer and shareholder alike resulting from false Williams Act filings.[46]

AN EXCHANGE PURSUANT TO A MERGER — NOT A 16(b) SALE

Abrams v. Occidental Petroleum Corp.

Section 16(b)[47] of the Securities Exchange Act of 1934[48] provides that a corporation may recover from a statutory insider[49] any profit made on its stock which is sold within six months of purchase. Despite an ostensibly clear purpose of preventing insiders from using their status to acquire information that will enable them to realize speculative profits through short-swing trading in the equity securities of their corporations, the section has had "both a litigious and controversial history."[50]

In *Abrams v. Occidental Petroleum Corp.*,[51] the Second Circuit was required to decide whether a tender offeror who derives a substantial profit from a defensive merger by the target corporation should be subject to section 16(b) liability. In exempting two profitable transactions, the court found no possibility for speculative abuse in appel-

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> potentially unlimited liability, it is submitted that such proof problems ought not to be considered at the outset on a motion to dismiss for lack of standing to sue.

Kellogg, *supra* note 35, at 116.

46 *See* note 40 *supra.*

47 15 U.S.C. § 78p(b) (1970).

48 15 U.S.C. § 78p (1970). The Securities Act Amendments of 1964 amended the Securities Act of 1934 and, for purposes of analysis, can be divided into two parts.

> The main feature of [the first] portion is an extension of the registration, periodic reporting, proxy and insider trading provisions of sections 12, 13, 14 and 16 of the Exchange Act to larger over-the-counter companies. These provisions were formerly applicable only to listed companies. . . . The second part of the act deals primarily with broker-dealers in securities and their personnel. It imposes upon such persons increased qualifications standards, as well as strengthened and refined administrative disciplinary controls.

R. Phillips and M. Shipman, *An Analysis of the Securities Acts Amendments of 1964*, 1964 DUKE L.J. 706-07 (1964). These amendments "constitute the most significant items of federal securities legislation since" 1940. *Id.* at 706.

49 The term statutory insider applies to any

> person who is directly or indirectly the beneficial owner of more than 10 per centum of any class of any equity (other than an exempted security) which is registered pursuant to [section 12 of the Securities Exchange Act of 1934], or who is a director or an officer of the issuer of such security.

15 U.S.C. § 78p(a) (1970).

50 Bateman, *The Pragmatic Interpretation of Section 16(b) and the Need for Clarification*, 45 ST. JOHN'S L. REV. 772 (1971) [hereinafter Bateman]. The author, in tracing the development of the current pragmatic interpretation of section 16(b) indicates that while most cases adopting this interpretive method have been clear in pointing out that 16(b) should be interpreted in the light of its purposes, these same courts have not been clear in discerning exactly what those purposes are. Despite an ostensible clarity of purpose within the statutory language, there remains unpredictability in the decisions.

51 450 F.2d 157 (2d Cir. 1971), *cert. granted*, 405 U.S. 1064 (1972).

lant Occidental's receipt of an irrevocable right to convert its target corporation holdings to preference stock of the other party to the merger nor was the possibility of abuse present in Occidental's granting an option to purchase the preference shares. As a result, neither the exchange pursuant to the merger, nor the option contract were found to be section 16(b) sales.

In the spring of 1967, Occidental determined that it would attempt an acquisition of the Kern County Land Company (Old Kern) and unilaterally announced a public tender offer to purchase Old Kern stock on May 8, 1967.[52] By May 10, enough Old Kern stock had been tendered to make Occidental a statutory insider under 16(b).

Old Kern resisted Occidental's tender offer and simultaneously carried on defensive merger talks with several other companies.[53] On May 19, Old Kern accepted an offer to sell its assets to Tenneco, Inc.,[54] a multi-faceted Delaware corporation. Realizing that a Tenneco-Old Kern merger would nullify its attempt to acquire a controlling interest in Old Kern, Occidental granted Tenneco an option to purchase all

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52 450 F.2d at 158. Occidental was convinced that ownership of a large block of Old Kern stock would be decisive in making the directors of Old Kern amenable to merger or consolidation proposals. As a preliminary to this end, Occidental purchased a total of 1900 shares of Old Kern stock in late April, 1967. However, since Occidental was not already, nor did it become, by these purchases, a beneficial owner of more than ten percent of Old Kern stock, no 16(b) liability was asserted with respect to these shares. 323 F. Supp. 570, 573 (S.D.N.Y. 1970).

The terms of the public tender offer published on May 9, 1967 committed Occidental to purchase all shares tendered up to 500,000 at $83.50 per share, and to pay an additional $1.50 commission on each share tendered through a broker. Both parties on appeal accepted the figure of $85 as Occidental's "per share cost of acquisition." The closing price of Old Kern stock on the New York Stock Exchange was $63.625 per share on the last trading day before the tender offer was announced. *Id.* at 574.

Actually, by May 10, 1967, two days after the tender offer announcement, more than 500,000 shares of Old Kern had been tendered. This was enough to make Occidental a beneficial owner of more than ten percent of Old Kern stock and, as such, a statutory insider within the provisions of 16(b). On May 11, 1967 Occidental extended its tender offer to encompass an additional 500,000 shares of Old Kern. As a result of additional purchases, by June 30, 1967, Occidental owned a total of 887,549 shares. However, Occidental only reported to the SEC ownership of 883,381 shares, its total holdings as of May 31, 1967. 323 F. Supp. at 574.

53 As was noted by the district court, the acquisition of more than ten percent of Old Kern's stock thrust Occidental Petroleum into an advantageous position vis-à-vis Old Kern. 323 F. Supp. at 574-75. As the largest stockholder, Occidental Petroleum could force a showdown with the management which might result in an Occidental takeover. On the other hand, if Occidental chose to stand pat, it could assert substantial influence in Old Kern's direction and possibly veto any attempts at a defensive merger. At the very least, Occidental could offer to divest itself, at a great profit, of its Old Kern stock to either Old Kern or any company seeking a merger. Needless to say, the directors of Old Kern faced Occidental's threatening posture with apprehension and determination to resist.

54 450 F.2d at 159. According to the terms of this agreement, in a one to one exchange, Old Kern stockholders would receive one share of a "new $5.50 preference voting stock of Tenneco, convertible into 3.6 shares of common stock." 450 F.2d at 159.

Tenneco shares that Occidental would receive as a result of the merger, for its holdings of Old Kern stock.[55]

Occidental, fearful that the defensive merger might result in 16(b) liability, offered a proposed rule to the SEC that would have exempted the transaction but it was not accepted.[56] Occidental had determined that, if the SEC did not provide a definitive answer to the question of 16(b) liability, it would "commence every kind of litigation it could reasonably bring and attempt to stall the consummation of the Tenneco [-Old Kern] transaction for six months."[57] However, this attempt to delay the merger failed[58] and, after Occidental tendered its Old Kern shares for Tenneco preference stock on December 11, 1967, New Kern (the corporation resulting from the merger) sought and obtained summary judgment for $23,511,337.94 against Occidental in the district court.[59]

The plaintiff presented two alternative theories to establish a "sale" within six months of Occidental's purchases which began on

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55 Occidental granted Tenneco an option to purchase at $105 per share. Tenneco paid $10 per share for the call, which was to be credited to the purchase payment upon exercise of the option. *Id.* at 159-60. Occidental had reported to its shareholders on May 19, 1967 that the estimated value of the new Tenneco stock was $105. 323 F.Supp. at 575.

56 In order to circumvent its potential liability under § 16(b) of the Securities Exchange Act of 1934 (*see* notes 47-49 *supra*), Occidental presented the SEC with proposed rule 16(b)-11. This proposed rule was designed to exempt tender offerors faced with a potentially profitable defensive merger from 16(b) liability.

Although the SEC first indicated a favorable reaction, it refused to publish for comment Occidental's proposal. After persistent efforts by Occidental, the SEC granted a formal hearing, held on August 29, 1967, to consider the proposed rule. The result of this hearing was that the SEC adhered to its earlier decision to abstain. 323 F. Supp. at 577.

The *Abrams* court refused to draw any inferences from the SEC's nonaction. However, the court noted the suggestion of appellant's counsel that the SEC might have felt the proposed rule was "inappropriate, since the Williams Bill with respect to tender offers, now §§ 13(d) and (e) and 14(d), (e) and (f) of the Securities Exchange Act, was pending before Congress." 450 F.2d at 160 n.7.

57 323 F. Supp. at 577.

Seeking to thwart the Tenneco-Old Kern merger, an Old Kern stockholder sued in a Texas state court and obtained a temporary injunction. When the court order was dissolved, that plaintiff, joined by his company and several associates, asked for similar relief in the United States District Courts for the Northern District of California and the District of Nebraska as well as in another Texas state court. Temporary restraining orders were granted by both the Nebraska federal court and the Texas state court on August 22, 1967. However, on the next day, the parties to the proposed merger succeeded in enjoining continued prosecution of the above suits after instituting an *ex parte* proceeding before the same Texas state court that had dissolved the original restraining order. *Id.* at 577.

58 450 F.2d at 161. Occidental also requested that the California Commissioner of Corporations withhold approval of the merger because it was unfair to Occidental. However, the Commissioner issued his approval on August 30, 1967 and the closing of the merger plan was held the same day. *Id.*

59 *Id.* In addition, three stockholder derivative actions were commenced for the same purpose. These four actions were consolidated.

May 8 and ended on June 8. New Kern first contended that, when the merger was completed on August 30, Occidental actually then sold its Old Kern shares because it became irrevocably entitled to Tenneco preference stock. It also argued that, in the alternative, Occidental sold its Old Kern stock when it granted Tenneco a purchase option on June 2.[60] The Second Circuit, after analyzing these transactions through a pragmatic method of interpretation[61] rejected both contentions and

[60] *Id.* at 161-62.

[61] The pragmatic method of interpreting and applying section 16(b) is the result of an evolutionary process which began approximately nine years after the statute was enacted. In 1943, the Second Circuit, in Smolowe v. Delendo Corp., 136 F.2d 231 (2d Cir.), *cert. denied,* 320 U.S. 751 (1943), was given the opportunity to elect between objective and pragmatic interpretations of section 16(b). In that case, the defendants contended that an actual showing of "unfair use of information" proscribed by the statute was an essential prerequisite to the penalty imposed. The court rejected that contention and opted for the objective interpretation after reviewing the congressional hearings on section 16(b). Testimony presented in those hearings expressly excluded intent of the wrongdoer from the elements necessary for liability. *See Hearings on Stock Exchange Practices Before the Senate Comm. on Banking and Currency,* 73d Cong., 2d Sess. 6557 (1934). The Second Circuit concluded that 16(b) "liability [is] based upon an objective measure of proof." 136 F.2d at 235.

This mechanistic approach was utilized by the federal courts during the next 15 years. Its potential for injustice was signaled when, in Park & Tilford Inc. v. Schulte, 160 F.2d 984 (2d Cir.), *cert. denied,* 332 U.S. 761 (1947), 16(b) liability attached to a sale of common stock to which preferred stock purchased more than six months previously had been converted. The Second Circuit, applying the literal or objective test, deemed the conversion a 16(b) "purchase" of the common stock. Since less than six months had passed between the conversion and sale, insider abuse was found.

The extension of 16(b) liability to cases involving convertible securities has since been curbed by rule 16(b)-9 which provides, *inter alia:*

> (a) Any acquisition or disposition of an equity security which . . . is convertible . . . into another equity security *of the same issuer* [emphasis added], shall be exempt from the operation of Section 16(b) . . . *Provided, however,* that this section shall not apply to the extent that there shall have been either (1) a purchase of any equity security of the class convertible . . . and a sale of any equity security of the class issuable upon conversion, or (2) a sale of any equity security of the class convertible and any purchase of any equity security issuable upon conversion . . . within a period of less than 6 months . . . .

17 C.F.R. § 240.16b-9 (1972).

At various times between 1952 and 1958 there were indications that the courts were willing to use a more subjective approach to 16(b) liability. *See, e.g.,* Roberts v. Eaton, 212 F.2d 82 (2d Cir.), *cert. denied,* 348 U.S. 827 (1954) (reclassification of stock to improve marketability was not a 16(b) purchase of the reclassified stock); Blau v. Mission Corp., 212 F.2d 77 (2d Cir.), *cert. denied,* 347 U.S. 1016 (1954) (exchange of stock between corporation and subsidiary was not a sale prior to creation of a public market for the shares); Rattner v. Lehman, 193 F.2d 564 (2d Cir. 1952) (Hand J. concurring) (recognized possible insider liability of a company which assigned a partner to care for its interests by electing him a director of the corporation whose shares were profitably traded).

The modern pragmatic approach requiring *a possibility of* speculative abuse was first enunciated by the Sixth Circuit. In Ferraiolo v. Newman, 259 F.2d 342 (6th Cir. 1958), *cert. denied,* 359 U.S. 927 (1959), after a review of prior cases, the court noted:

> Every transaction which can reasonably be defined as a purchase will be so defined, if the transaction is of a kind which can *possibly* lend itself to the speculation encompassed by Section 16(b).

Id. at 345 (emphasis added).

The Ninth Circuit adopted the "possibility of speculative abuse" test in Blau v. Max reversed the lower court ruling by ordering the entry of summary judgment for Occidental. First, the court of appeals did not accept the district court's interpretation of *Newmark v. RKO General, Inc.*,[62] where the Second Circuit held that an exchange pursuant to a merger may be a sale. The court emphasized that an "indispensable predicate" for liability in *Newmark* was the existence of the potential for speculative abuse that inhered in RKO's *knowledge* of the impending merger and its power to exert control over the whole transaction.[63] These facts clearly distinguished *Newmark* from *Abrams* where defendant Occidental had no such knowledge or control, thus negating the opportunity for speculative abuse. In addition to noting *Newmark*'s dictum that an exchange pursuant to a merger is not per se a 16(b) sale,[64] the court also referred to the "proper criterion"[65] espoused in *Blau v. Lamb*[66] wherein a conversion of stock was not deemed a 16(b) purchase. There, the court noted that the first consideration determinative of whether or not a transaction constitutes a 16(b) purchase or sale is the potential for unfair insider trading which 16(b) was enacted to prevent. Speculation, either actual or potential, was cited as the only abuse at which 16(b) was directed.[67]

The court concluded that Occidental's lack of either knowledge of the impending merger or control of it precluded a possibility of speculative abuse. Therefore, the closing of the Tenneco-Old Kern merger was not a sale under 16(b).

Appellees' second contention that the June 2 option agreement invoked 16(b) liability was rejected notwithstanding the statutory definition of "sale" as inclusive of a "contract to sell."[68] The Second Circuit adhered to its pre-established rule which excludes from 16(b) sales grants of options to purchase stock.[69] An exercise of the option, *i.e.*, a transfer of the shares covered by the option, is a prerequisite to a 16(b) sale. The court did note that this rule is not inviolable and would not

Factor & Co., 342 F.2d 304, 307 (9th Cir.), *cert. denied*, 382 U.S. 892 (1965) and the Second Circuit finally conformed in Blau v. Lamb, 363 F.2d 507, 516 (2d Cir. 1966), *cert. denied*, 385 U.S. 1002 (1967). Thus, the pragmatic criterion for insider liability was gradually adopted by the circuits. *See* Pettys v. Butler, 367 F.2d 528 (8th Cir. 1966), *cert. denied*, 385 U.S. 1006 (1967). *But see* Heli-Coil Corp. v. Webster, 352 F.2d 156 (3d Cir. 1965).

[62] 425 F.2d 348 (2d Cir.), *cert. denied*, 400 U.S. 854 (1970).

[63] 450 F.2d at 163.

[64] *Id.* at 162.

[65] *Id.* at 163.

[66] 363 F.2d 507 (2d Cir. 1966), *cert. denied*, 385 U.S. 1002 (1967).

[67] *Id.* at 521.

[68] 450 F.2d at 164.

[69] *Id. See* Silverman v. Landa, 306 F.2d 422 (2d Cir. 1962).

be followed when the substance of a sale is disguised in the form of an option agreement.[70]

The court noted that two significant factors should control such a determination: first, whether the down payment is so large in relation to the price of the option as to preclude, for all practical purposes, its forfeiture; and, second, whether the price is "below any reasonable expectation [of the market value] at the end of the option period. . . ."[71] However, neither criterion for a coercive option (sale for 16(b) purposes) was met in the instant case.[72]

To support their contention that an option agreement constitutes a 16(b) sale, appellees relied on *Bershad v. McDonough*[73] which so held. In that case, however, the option agreement was a sham. The grant of purchase rights had been accompanied by a proxy giving the optionee irrevocable voting control of the stock. Furthermore, immediately following the transaction, the optionor and an associate director had resigned and were replaced by agents of the optionee. The Second Circuit found *Bershad* inapposite by examining substance rather than form.[74]

In declining to find that execution of the option agreement constituted a 16(b) sale, the court noted that the result might be otherwise had Occidental thereby acquired an option to sell after termination of the statutory six-month period instead of granting an option to buy. A transaction of the former type would have ensured receipt of an acceptable price for the shares after the six-month liability period had run. Also, since exercise of the option would be at Occidental's discretion, any increase in the market value of the shares over the waiting period would inure to its added benefit. However, since the transaction involved the grant of a "call" and not the acquisition of a "put" there was no unconscionable act.[75] Finding the option agreement to be the logical solution to a legitimate business problem, the Second Circuit declined

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70 450 F.2d at 164.

71 *Id.*

72 "There was undisputed testimony that the forfeitable down payment, 10.05%, was a reasonable, non-coercive price. . . ." *Id.*

Tenneco argued that its only concern was that it buy out Occidental as a large minority stockholder. However, the court retorted that the option was a true option since, although it was true that Tenneco would not feel comfortable while Occidental controlled a substantial portion of its stock, a depression in the market would likely preclude the exercise of the option. This result would be dictated by good economic sense and the threat of stockholder derivative suits for waste.

73 428 F.2d 693 (7th Cir.), *cert. denied*, 400 U.S. 992 (1970).

74 450 F.2d at 165.

75 *Id.*

to exercise its acknowledged power to find a sale in a transaction not normally recognized as such.[76]

The *Abrams* decision is consistent with the trend away from a mechanistic interpretation of section 16(b) toward a more pragmatic one.[77] In addition to the potential for injustice inherent in the former approach, its abandonment may be attributed in part to parallel developments in state law[78] and the expanded role of rule 10b-5.[79]

Possibly the most significant aspect of *Abrams* is its dictum. The court declared, "indeed, if we considered the question here under discussion to be closer than we do, we would be seriously concerned over the policy implications of ruling in appellees' favor."[80] The Second Circuit thus indicated that, should another court disagree with the "speculative abuse" standard for determining whether an exchange pursuant to a merger constitutes a 16(b) sale, there are independent public policy reasons for reaching the same result. These considerations are twofold. First, a target company would be able to cite as an asset a tender offeror's potential 16(b) liability and thereby "bait" another company into a defensive merger. The court felt that it would be inequitable to so deprive a tender offeror of a share of the profits that

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76 *Id.*

77 *See* note 61 *supra.*

78 *See, e.g.,* Diamond v. Oreamuno, 24 N.Y.2d 494, 248 N.E.2d 910, 301 N.Y.S.2d 78 (1969), where it was held that "officers and directors may be held accountable to their corporation for gains realized by them from transactions in the company's stock as a result of their use of material inside information." *Id.* at 496, 248 N.E.2d at 911, 301 N.Y.S.2d at 79. Defendants contended on appeal that, because federal law may apply, the state action should be dropped to avoid double liability. The court rejected this contention, maintaining that federal law had not preempted the field. (It is doubtful if a 16(b) action could have been brought in this case because defendants held the securities for over six months.)

> By exacting common law liability for trading profits realized outside the six month period, state common law is operative where section 16(b) is not, since a period of six months or less is necessary to invoke the federal statute. Similarly, the *Diamond* rule is needed where the jurisdictional standards of section 16(b) cannot be met because the corporation is not subject to the regulatory requirements of the Securities Exchange Act of 1934. Consistently applied, the *Diamond* result would supplement section 16(b) liability in these important respects.

Folk, III, *Corporation Law Developments—1969,* 56 VA. L. REV. 755, 797-98 (1970).

However, reliance on common law principles deprives a plaintiff of the more desirable 16(b) requirements concerning burden of proof and damage determination. *Id.* at 798.

79 With respect to the dynamic expansion of rule 10b-5, *see* SEC v. Texas Gulf Sulphur Co., 401 F.2d 833 (2d Cir. 1968), *cert. denied,* 404 U.S. 1005 (1971); Cady, Roberts & Co., 40 S.E.C. 907 (1961); *In re* Merrill Lynch, Pierce, Fenner & Smith, Inc., SEC Exch. Act Release No. 8,459 (Nov. 25, 1968). *See also* A. BROMBERG, SECURITIES LAWS: FRAUD — SEC RULE 10b-5, §§ 2.1-2.3 (1970); Weiskopf, *Remedies Under Rule 10b-5,* 45 ST. JOHN'S L. REV. 733 (1971); Painter, *Rule 10b-5: The Recodification Thicket,* 45 ST. JOHN'S L. REV. 699 (1971); Macey, *Protection of Creditors' Rights Through Use of Rule 10b-5,* 76 COM. L.J. 133 (1971); Note *"Federal Corporation Law" and 10b-5: The Case for Codification,* 45 ST. JOHN'S L. REV. 274 (1970).

80 450 F.2d at 163.

would not be available but for its initial bid. Second, the incentive to make tender offers for more than 10 percent of a company's stock would be seriously diminished since the maker of an unsuccessful takeover offer might be deprived of any gain by the unilateral maneuvers of a target corporation. Since tender offers are important means to effect an appreciation of stock or to replace inefficient management, their discouragement would be detrimental to stockholders of target corporations.

It would indeed be anomalous to deprive stockholders of potential benefit through a mechanistic application of section 16(b) which was designed to protect such stockholders. The Second Circuit, by recognizing the value of tender offers,[81] has avoided this anomaly.

SIPC — A First Impression

SEC v. Alan F. Hughes, Inc.

Created by the Securities Investor Protection Act of 1970 (1970 Act),[82] the Securities Investor Protection Corporation (SIPC) is a nonprofit membership corporation[83] whose fundamental objective is to provide financial protection for the customers of failing brokers and dealers (broker-dealers).[84] SIPC encountered its initial constitutional challenge in *SEC v. Alan F. Hughes, Inc.*[85] where the Second Circuit held that the statutory scheme under which customers of a broker-dealer are adjudicated to be in need of the protection of the 1970 Act is consistent with due process. The application of the statutory scheme, the court opined, was proper as evidenced by the record before it.[86]

All persons registered as broker-dealers under the Securities Exchange Act of 1934[87] and all persons, with certain specified exceptions,[88]

[81] The Second Circuit has previously provided protection for tender offerors. In Crane Co. v. Westinghouse Air Brake Co., 419 F.2d 787 (1969), the court held an investor liable under sections 9a(2) and 10(b) to a tender offeror whose offer was effectively negated by defendant's fraudulent manipulation of the price of the target company's stock.

[82] 15 U.S.C. §§ 78aaa *et seq.* (1970).

[83] 15 U.S.C. § 78ccc(a)(2). SIPC has all the powers, unless inconsistent with the 1970 Act, conferred upon a corporation under the District of Columbia Nonprofit Corporation Act. *Id.* § 78ccc(a)(3).

[84] 1 SIPC Ann. Rep. 6 (1971). The term broker-dealer will be used to describe those brokers and dealers who are registered under section 15(b) of the Securities Exchange Act of 1934 (15 U.S.C. § 78*o*) and those who are members of a national exchange. *See* Gates, *The Securities Investor Protection Act of 1970: A New Federal Role in Investor Protection*, 24 Vand. L. Rev. 586 n.2 (1971).

[85] 461 F.2d 974 (2d Cir. 1972).

[86] *Id.* at 981.

[87] *See generally* 15 U.S.C. § 78*o* (1970).

[88] *See* 15 U.S.C. § 78ccc(a)(2)(B) (1970). Those excepted from the membership requirement include persons whose "business as a broker or dealer consists exclusively of (i) the distribution of shares of registered open end investment companies or unit investment trusts,