The Pragmatic Interpretation of Section 16(b) and the Need for Clarification

Hal M. Bateman
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FOR CLARIFICATION

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Despite its ostensible simplicity and the general wholesomeness of its stated purpose, section 16(b) of the Securities Exchange Act of 1934 has had both a litigious and a controversial history. Nevertheless, it has endured without statutory change for thirty-seven years. Designed to prevent unfair use of corporate information by insiders in short-swing, speculative trading in the securities of the company, this provision makes all profits realized by such insiders from such trading recoverable by the corporation. An expeditious suit to recover the profits, which may be brought either by the corporation or by a shareholder on its behalf, is expressly created by the section. In many of the cases, the courts have been confronted with the need to interpret the provisions of 16(b) in relation to a wide range of issues and transactions. This has, in turn, frequently compelled the courts to consider the basic principles and methods of interpretation to be used in resolving issues under the section.

It has been accurately observed that in the course of this interpretive process there has been a distinct change in the method and principles of interpretation used. In the early cases which interpreted section 16(b) for the first time, the courts adopted an extremely literal and often harsh interpretation of its provisions, which has since come to be known as the objective method. For many years, this was the generally accepted method of interpretation. In later cases which presented even more difficult issues, however, the courts gradually began to move to a more pragmatic or subjective approach to the interpretation of 16(b), which has placed relatively more emphasis on the policy of the statute and less on its literal terms. While this transition has been taking place, there have also been important developments in

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*Professor of Law, University of Missouri-Columbia, School of Law. B.A., Rice University, 1954; J.D., Southern Methodist University, 1956.


2 Lowenfels, Section 16(b): A New Trend in Regulating Insider Trading, 54 CORNELL L. REV. 45 (1968). Mr. Lowenfels' distinguished article is an important analysis of this development, to which the author is indebted. See also Painter, The Evolving Role of Section 16(b), 62 MICH. L. REV. 649 (1964); Note, Stock Exchanges Pursuant to Corporate Consolidation: A Section 16(b) "Purchase or Sale?", 117 U. PA. L. REV. 1034 (1969).
related areas of the law — particularly the explosive developments under SEC rule 10b-5—which may have influenced the courts in part.

As the inevitable consequence of these developments, greater unpredictability and uncertainty have resulted in many cases with respect to the applicability of section 16(b). Although most of the courts in recent cases have accepted the newer pragmatic method of interpretation explicitly or implicitly, their handling of it has not been free of difficulty. It is the purpose of this article to review in general outline the transition which has occurred in the courts' approach in interpreting the section, to examine some of the recent cases which have undertaken the application of the new pragmatic method of interpretation, and to comment on the directions the courts should consider in future cases.  

STRUCTURE AND PURPOSE OF SECTION 16(b)

Both the liability and the remedy created by 16(b) are specified in the statutory language:

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 the request or shall fail diligently to prosecute the same thereafter; but no such suit shall be brought more than two years after the date such profit was realized. This subsection shall not be construed to cover any transaction where such 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

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4 Since the Lowenfels article provides a thorough analysis of the development of the new pragmatic method of interpretation, this will only be reviewed in broad outline here. See Lowenfels, supra note 2.
regulations may exempt as not comprehended within the purpose of this subsection.\textsuperscript{5}

Insiders subject to the provision are defined in section 16(a) as officers and directors of issuers which have an equity security registered under section 12 of the Exchange Act\textsuperscript{6} and beneficial owners of more than 10 percent of any such security. Liability extends to any profit realized by an insider from any short-swing transaction in any equity security of the issuer. Any combination of sale and purchase of such security within less than six months of each other may be used to establish both the profit realized and the short-swing transaction within 16(b), regardless of the sequence of transactions or the identity of shares, since all shares of the same class are treated as fungible.\textsuperscript{7} A suit to recover any such profit realized may be brought either by the corporation or by a security holder on its behalf, and in the latter event, generous attorney's fees are customarily allowed to the successful plaintiff.\textsuperscript{8} Due to section 27 of the Exchange Act, the federal courts have exclusive jurisdiction of suits under section 16(b), with liberal venue and nationwide service of process.\textsuperscript{9}

The explicit statement of purpose in the opening lines of 16(b) has given rise to some of the problems of interpretation. Obviously, it is the general purpose of the section to prevent the unfair use of corporate information by insiders in trading. But it is not clear from the statute itself whether either access to or actual use of corporate

\textsuperscript{5} 15 U.S.C. § 78p(b) (1964).
\textsuperscript{6} 15 U.S.C. § 78l (1964). The section requires two groups of issuers to register their securities: (1) issuers whose securities are listed on a national securities exchange, and (2) any other issuers which have total assets exceeding $1,000,000, and a class of equity security held of record by 500 or more persons, subject to a limited number of exemptions. These corporations and their insiders are within section 16(b) of the Act by virtue of the definitive provisions in section 16(a), 15 U.S.C. § 78p(a) (1964). The terms “director” and “equity security,” which are key terms in both 16(a) and 16(b), are themselves defined in §§ 3(a)(7) and (11), 15 U.S.C. § 78c(a)(7) and (11) (1964). The term “officer” is defined in SEC rule 3b-2, 17 C.F.R. § 240.3b-2 (1970).
\textsuperscript{8} The policy reason behind this custom is to encourage the enforcement of the section. This, like much else in the development of 16(b), had its origin in Smolowe v. Delendo Corp., 196 F.2d 281 (2d Cir.), cert. denied, 320 U.S. 751 (1943), where the court in approving the award of a substantial attorney's fee to the successful plaintiff, stated: “Since in many cases such as this the possibility of recovering attorney's fees will provide the sole stimulus for the enforcement of section 16(b), the allowance must not be too niggardly.” Id. at 241. This has been criticized as undesirably champertous and an unwise enforcement device. 2, 5 L. Loss, Securities Regulation 1051-55, 3017-21 (2d ed. 1961, Supp. 1969) [hereinafter Loss].
information by the insider defendant is a necessary element in the plaintiff's case. Since the remedy was clearly intended by the draftsmen to be highly efficient and virtually automatic, with difficult problems of proof being reduced to a minimum, the courts have traditionally rejected any contention that either possession or use of inside information need be shown. Nor has proof of the absence of any inside information been regarded as a defense.

On the other hand, the liability and the remedy created by section 16(b) are limited to a specific abuse by corporate insiders of their access to corporate information—namely, profiting from speculative short-swing trading in the equity securities of the corporation. There is no indication in the language of section 16(b) that the statement at its outset concerning the general purpose to which it is related should be used to expand the reach of the specific liability and remedy it creates in an attempt to redress all abuses by insiders of their corporate position. A more reasonable interpretation is that the section was intended only to deal with short-swing speculative trading by insiders as one measure toward achieving the general goal of preventing the unfair use of corporate information by insiders. The significance of the determination of the purpose intended to be achieved by 16(b) becomes more apparent after a review of the interpretive problems which have been encountered by the courts.

**EARLY CASES AND THE OBJECTIVE INTERPRETATION**

The first decisions which dealt with the problem of interpreting section 16(b) unequivocally adopted what has since become known as the objective or literal method of interpretation. In these cases, the courts concluded that the only issues to be determined were whether the defendant was an insider subject to the section and whether he had engaged in any combination of sale and purchase of an equity security of the issuer within less than six months which, when matched, indicated a profit. The plaintiff was neither required to show culpable

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10 In hearings before the Senate Committee on Banking and Currency prior to enactment of the Securities Exchange Act of 1934, Mr. Thomas G. Corcoran, a principal draftsman of the Act and chief spokesman for it before Congress during its consideration, testified with respect to section 16(b):

You hold the director, irrespective of any intention or expectation to sell the security within 6 months after, because it will be absolutely impossible to prove the existence of such intention or expectation, and you have to have this crude rule of thumb, because you cannot undertake the burden of having to prove that the director intended, at the time he bought, to get out on a short swing.

Hearings on Stock Exchange Practices Before the Senate Comm. on Banking and Currency, 73rd Cong., 2d Sess. 6557 (1934); see also 2 Loss 1040-44.

11 See Munter, Section 16(b) of the Securities Exchange Act of 1934: An Alternative to "Burning Down the Barn to Kill the Rats," 52 CORNELL L.Q. 69 (1966); 2 Loss 1040-44.
intent on the part of the defendant nor that the defendant had actually possessed inside information when he traded. These cases also held that profit within the meaning of 16(b) was determined only by matching the lowest purchase price with the highest sale price without regard to either actual losses realized by the insider on other transactions in the same security or to rules of tracing the identity shares or of averaging purchase prices and sale prices. In adopting this objective method of interpretation, the courts used as a fulcrum the now famous description of section 16(b) by Mr. Thomas G. Corcoran, chief spokesman for its draftsmen, as a "crude rule of thumb," although the relatively narrow context in which this description was used has frequently been overlooked.

The first of these early cases was Smolowe v. Delendo Corp. in which the court not only held that section 16(b) was constitutional but also disposed of two basic issues with respect to its interpretation. First, the court rejected the use of any subjective standard of proof in actions under the section which would require the plaintiff to show actual unfair use of inside information as a prerequisite to the defendants' liability. In explicit language, the court concluded that the opening phrase of 16(b) merely states its general purpose and was not intended to create any issue of fact in the cases. Second, the court held that

To illustrate this method of determining "profit realized", assume that the insider executes the following transactions in an equity security of the section 12 issuer in the same year:

January 10 — Buys 100 shares at $90.
February 10 — Sells 100 shares at $75.
March 1 — Buys 100 shares at $60.
April 1 — Sells 100 shares at $20.
May 1 — Buys 100 shares at $10.
May 15 — Sells 100 shares at $40.

Although the insider might insist that he had actually realized a loss on every pair of transactions in chronological sequence, with a total realized loss of $6,500, the traditional rule under 16(b) would hold that he was liable to the issuer for a "profit realized" of $2,500, determined by matching the May 1 purchase at $50 with the February 10 sale at $75 and disregarding all other transactions in the same period. Gratz v. Claughton, 187 F.2d 46 (2d Cir.), cert. denied, 341 U.S. 920 (1951); Smolowe v. Delendo Corp., 136 F.2d 231 (2d Cir.), cert. denied, 320 U.S. 751 (1943).

See note 10 supra. The comment seems clearly concerned only with the language in 16(b) which expressly excludes consideration of any issue of whether the insider intended from the outset to complete the trading transactions within less than six months. See Lowenfels, supra note 2, at 60-61.

14 Had Congress intended that only profits from an actual misuse of inside information should be recoverable, it would have been simple enough to say so. Significantly, however, it makes recoverable the profit from any purchase and sale, or sale and purchase, within the period. The failure to limit the recovery to profits gained from misuse of information justifies the conclusion that the preamble was inserted for other purposes than as a restriction on the scope of the Act.

Id. at 236.
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“profit realized” within the meaning of the section was to be determined by matching the highest sale price with the lowest purchase price among the defendant's transactions in securities of the same class within any period of less than six months. In this respect the court rejected the defendants' arguments (1) that they were entitled to trace specific shares through the identification of certificates used in purchases and sales, (2) that the rule of first in, first out could be used to match purchases and sales for 16(b) purposes, and (3) that the defendants could use average purchase prices and average sale prices to reduce their liability. The court concluded that

the statute was intended to be thoroughgoing, to squeeze all possible profits out of stock transactions, and thus to establish a standard so high as to prevent any conflict between the selfish interest of a fiduciary officer, director, or stockholder and the faithful performance of his duty. . . . The only rule whereby all possible profits can be surely recovered is that of lowest price in, highest price out—within six months—as applied by the district court. We affirm it here, defendants having failed to suggest another more reasonable rule.16

A few years later, the same court in Gratz v. Claughton17 dealt further with the interpretation of "profit realized" and with the method of profit computation to be used in 16(b) cases. Here, the court reaffirmed the position taken in Smolowe based on the concept that all shares of stock of the same class are fungible and held that the only way to give full effect to the congressional purpose to squeeze all possible profits out of insider short-swing trading is to match the defendant's lowest purchase prices with his highest sale prices in any two transactions involving the same number of shares of the same class within less than six months of each other. In addition, the court refused to allow any recognition of offsetting losses realized by the defendant on other transactions in the same security, to reduce the profit recoverable under the section.18

In the same era, the Second Circuit also decided Park & Tilford,

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16 Id. at 239.
17 187 F.2d 46 (2d Cir.), cert. denied, 341 U.S. 920 (1951). The court again upheld the constitutionality of the section and further held, that venue laid in any district where any part of the 16(b) transaction occurred is proper.
18 Perhaps the disallowance of offsetting losses was the most stunning aspect of the court's ruling. Under the method of computation required by the court, defendant Claughton was liable for 16(b) profits of approximately $300,000. However, it appeared that the defendant had actually suffered losses of over $400,000. Hence, the net detriment to defendant Claughton, including both actual losses and 16(b) liability, was roughly $700,000. See Adler v. Klawans, 267 F.2d 840, 847-48 (2d Cir. 1959); 2 Loss 1063-64 (regarding the actual losses involved).
Inc. v. Schulte\textsuperscript{18} which, for the first time, presented the problem of the applicability of 16(b) to transactions in convertible securities under the literal or objective method of interpretation. Members of the Schulte family, which dominated Park & Tilford, had converted their shares of Park & Tilford convertible preferred into common stock and had subsequently sold the common stock within six months after the conversion date. The sale price of the common stock was well above the value of the preferred or the common on the date of the conversion and the Schultes were unquestionably 16(b) insiders. The principal issue, which became increasingly important in subsequent cases, was whether the conversion of the preferred stock had constituted a "purchase" of the common stock received upon conversion. The court, in unqualified language, held that it did:

[A] conversion of preferred into common stock followed by a sale within six months is a "purchase and sale" within the statutory language of Section 16(b). Whatever doubt might otherwise exist as to whether a conversion is a "purchase" is dispelled by the definition of "purchase" to include "any contract to buy, purchase, or otherwise acquire" Section 3(a)(13). Defendants did not own the common stock in question before they exercised their option to convert; they did afterward. Therefore they acquired the stock, within the meaning of the Act. The Act certainly applies as well to executed acquisitions as to executory contracts to acquire. Not otherwise could the Act accomplish the Congressional purpose to protect the outside stockholders against at least short-swing speculation by insiders with advance information.\textsuperscript{20}

The unyieldingly literal or objective method of interpretation established in these famous early cases became the generally accepted one and was followed in numerous subsequent cases to reach similar results. As a consequence, 16(b) became widely regarded as "arbitrary", "Draconian", "a trap for the unwary", and "probably the most cordially disliked provision in all these statutes from the point of view of those whom it affects."\textsuperscript{21} It is perhaps significant, however, that at the time this severe method of interpretation was becoming established, there was relatively little else in the law to restrain corporate insiders in the use of their special access to corporate information to their private advantage in securities transactions. The judicial development under rule 10b-5 was in its infancy, and state law varied widely in effective-

\textsuperscript{18} 160 F.2d 984 (2d Cir.), cert. denied, 332 U.S. 761 (1947).
\textsuperscript{20} Id. at 987.
\textsuperscript{21} See W. Painter, Federal Regulation of Insider Trading 36 (1968); 2 Loss 1087-90; Munter, supra note 11.
ness and presented substantial procedural problems. Hence, section 16(b) represented by far the most effective means available to the courts to restrain insider trading with access to corporate information. This fact may have contributed to the severity of the method of interpretation which the courts adopted.

**Evolution of the Pragmatic Method of Interpretation**

Although the objective method became widely accepted, it soon began to be challenged as the courts were confronted with more difficult issues in novel situations. This was probably due in part to the unusually litigious enforcement mechanism built into 16(b) and in part to the increasing popularity of convertible securities and options. In dealing with these problems, the courts began to recognize the necessity to consider the section's basic purposes in order to determine whether a particular case presented the possibility of the type of abuse which 16(b) was intended to prevent. In many cases, this became the central issue. In time, this subjective pragmatic method of interpretation has become accepted by most courts with respect to many of the issues in section 16(b) cases. This has allowed for a more just result in many instances. But it has also created greater uncertainty and unpredictability, and occasionally it has produced surprising results.

Perhaps the first intimation that a more flexible approach to 16(b) interpretation was possible was the suggestion by Judge Learned Hand in his concurring opinion in *Rattiner v. Lehman*. The issue before the court was whether the individual defendant, Hertz, who was both a director of a corporation registered under section 12 and a partner in Lehman Brothers, which had realized short-swing profits from trading in the corporation's stock was liable under section 16(b) for all of Lehman Brothers' profits, or whether in the alternative, his partners might be considered directors for 16(b) purposes. The court held that Hertz alone came within the statutory definition of director and was liable only for his share of the firm’s profit. Judge Hand, while agreeing with this result on these particular facts, was unwilling to concede that it would not be possible on appropriate facts for the partnership and its members to be deemed directors within 16(b) if

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22 This device has been criticized as champertous. See 2 Loss 1041-42, 1051-55, 1090; Hamilton, *Convertible Securities and Section 16(b): The End of an Era*, 44 Texas L. Rev. 1447, 1450 (1966). Professor Loss urges administrative enforcement instead. 5 Loss 3017-21.


24 193 F.2d 564 (2d Cir. 1952).
one of the partners had in fact been deputized by the firm to sit on the board of directors.\textsuperscript{25}

A similar approach to interpreting the section was used in \textit{Blau v. Mission Corp.}\textsuperscript{26} The defendant, Mission Corporation, owned more than 10 percent of the common stock of Tide Water Associated Oil Company, which was registered under 12(g) of the Exchange Act. On two occasions, the defendant had transferred its Tide Water shares to a subsidiary of the defendant in exchange for stock of the subsidiary. However, between the time of the first exchange and the time of the second exchange the common stock of the subsidiary had been distributed to the public and listed on the New York Stock Exchange. The court distinguished the two exchanges between the defendant and its subsidiary on the basis that when the first exchange occurred, the defendant owned all of the subsidiary's stock and the transfer was therefore, "a mere transfer between corporate pockets,"\textsuperscript{27} but that when the second exchange occurred, the shares of the subsidiary received by the defendant had a public market. The court concluded, therefore, that the second exchange was a "sale" within the meaning of section 16(b), while the first was not, reasoning that "[t]o hold otherwise would be to place entirely undue stress on the corporate fiction reaching harsh and wooden results quite unnecessary to achieve the purposes of the act."\textsuperscript{28}

Based on the approach it had taken in \textit{Mission Corp.}, the Second Circuit later in the same year decided \textit{Roberts v. Eaton},\textsuperscript{29} in which it held that a reclassification of common stock into common and preferred through amendment of the articles of incorporation was not a "purchase" of the new stock within 16(b). After examining various factors pointing to this result, the court concluded:

\begin{quote}
[I]t seems quite possible that no one of the factors we have enumerated, standing alone, would be sufficient for that result. But in cumulative effect we think they are. \textit{The reclassification at bar could not possibly lend itself to the speculation encompassed by Section 16(b).} This being so, it was not a "purchase" and the decision below was correct.\textsuperscript{30}
\end{quote}

\textsuperscript{25}I agree that section 16(b) does not go so far; but I wish to say nothing as to whether, if a firm deputized a partner to represent its interests as a director on the board, the other partners would not be liable. True, they would not even then be formally "directors"; but I am not prepared to say that they could not be so considered; for some purposes the common law does treat a firm as a jural person.

\textit{Id.} at 566-67 (Hand, J., concurring).

\textsuperscript{26}212 F.2d 77 (2d Cir.), \textit{cert. denied}, 347 U.S. 1016 (1954).

\textsuperscript{27}\textit{Id.} at 80.

\textsuperscript{28}\textit{Id.} (emphasis added).

\textsuperscript{29}212 F.2d 82 (2d Cir.), \textit{cert. denied}, 348 U.S. 827 (1954).

\textsuperscript{30}\textit{Id.} at 86 (emphasis added).
Although these cases presented some departure from strict literalism in 16(b) interpretation, the major evolution of the pragmatic or subjective method of interpretation occurred in a series of later cases which struggled with the problems presented by convertible securities. The fundamental issues in these cases were whether conversion of the convertible security into the underlying security constitute a "sale" of the convertible security and a "purchase" of the underlying security within the meaning of the section. Literally interpreted, 16(b) coupled with the definitions of "purchase" and "sale" in section 3, seemed to require an affirmative answer to both questions. This was reinforced by the decision in Park & Tilford. But the courts were confronted with the fact that this could easily produce absurdly harsh and unjust results, unnecessary to the accomplishment of the basic purpose of 16(b).

The first of these cases was Ferraiolo v. Newman in which Judge (now Mr. Justice) Potter Stewart, writing for the Sixth Circuit, after examining earlier decisions, concluded that "the standard that emerges from these decisions can be simply stated: Every transaction which can reasonably be defined as a purchase will be so defined, if the transaction is of a kind which can possibly lend itself to the speculation encompassed by Section 16(b)." Applying this standard, Judge Stewart decided that on the facts of the case before him the defendant's conversion of convertible preferred into common stock did not constitute a "purchase" of the common stock within the meaning of 16(b).

The next major decision in this group was Blau v. Max Factor & Co. in which members of the family which controlled the corporate issuer exchanged their common stock pursuant to a conversion right for substantially similar class A stock which had a public market. Within less than six months thereafter the class A stock received in the exchange was sold to the public. The Ninth Circuit held that on the facts of this case the conversion did not constitute a purchase of the class A stock for the purposes of 16(b). To reach this result the court explicitly embraced the pragmatic method of interpretation of 16(b) in the following language:

Thus, a transaction is held to be a "purchase" within Section 16(b) "if in any way it lends itself to the accomplishment of what the

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31 Since this development has been carefully analyzed elsewhere, it will only be given summary treatment here. See W. Painter, supra note 21, at 42-52; Hamilton, supra note 22.
32 See note 7 supra.
34 Id. at 345 (emphasis added).
35 342 F.2d 304 (9th Cir.), cert. denied, 382 U.S. 892 (1965).
statute is designed to prevent". . . . On the other hand, to avoid purposeless harshness, a transaction is held not to be a Section 16(b) "purchase" if it "was not one that could have lent itself to the practices which Section 16(b) was enacted to prevent."36

That this approach to 16(b) interpretation was neither predictable nor unanimously accepted became apparent in the decision the same year by the Third Circuit in *Heli-Coil Corp. v. Webster.*37 There, the court reviewed the earlier cases, flatly rejected the developing pragmatic method of interpretation and reaffirmed the objective interpretation. It concluded, therefore, that the conversion of convertible debentures into common stock constituted both a "sale" of the debentures and a "purchase" of the common stock, within the meaning of 16(b), both of which might be used to produce a profit recoverable under the section. The importance of this decision, however, was limited by the fact that the court was badly divided,38 and by two major decisions the following year in the Second and the Eighth Circuits, both of which accepted the pragmatic view.

The major issue which confronted the Second Circuit in *Blau v. Lamb*39 was whether the conversion of convertible preferred into common stock constituted a "sale" of the preferred within the meaning of section 16(b). The court, adopting the pragmatic approach, concluded that the preferred and the common were in fact economic equivalents and therefore, that the conversion should not be construed as a "sale" of the preferred. In reaching this conclusion, the court stated that prior decisions did not require it to treat the conversion as a sale regardless of analysis and that

[i]nstead, most of the appellate decisions, including the more recent decisions of our court, state that the application of Section 16(b) depends upon whether the transaction in question could tend to accomplish what the section was designed to prevent. . . . Congress adopted the sweeping, arbitrary regulatory mechanism embodied in Section 16(b) in order to insure that even the possibility of insider abuse was deterred, but it would seem to follow that in order to avoid "purposeless harshness" a court should first inquire whether a given transaction could possibly tend to accomplish the practices Section 16(b) was to prevent. . . . In some cases, however, this initial inquiry will convince a court that the conversion transaction in question could not possibly have lent itself to insider

36 Id. at 307.
37 352 F.2d 156 (3d Cir. 1965).
38 The case was decided by a panel of eight judges of the Third Circuit, only four of whom joined in the majority opinion.
abuse. In such a case it is not inconsistent with Section 16(b)'s regulatory mechanism to hold that the section does not apply.\(^4\)

The Eighth Circuit followed suit in \textit{Petteys v. Butler}\(^4\) in which it held that under the particular circumstances the conversion of convertible preferred stock into common stock did not constitute a "purchase" of the common within the meaning of 16(b). In reaching this result, the court discussed the development of the pragmatic method of interpretation in the foregoing cases and concluded that

notwithstanding the broad language in the Park & Tilford case and ruling in Heli-Coil Corporation \textit{v. Webster}, we believe the rule has been clearly established by a majority of the circuits, that each case must be examined on its own particular facts. If, from an examination of the particular facts, a transaction is of a kind that can possibly lend itself to the speculation encompassed by Section 16(b) and falls within the broad definitions of "purchase" and "sale," it will be so defined. However, if an examination of the facts indicates that there is no possibility of abuse, there is no need to apply a Section 16(b) label to the transaction. . . . A facet to consider as militating against painting every conceivable conversion with the same broad brush, regardless of the lack of opportunity for short-swing market manipulation, is the manifestly absurd and unfair result that can flow from such a \textit{per se} black-letter rubric.\(^4\)

Most of the problems relating to convertible securities and section 16(b) have ultimately been resolved by rule 16b-9.\(^4\) However, the development in these cases of a new pragmatic approach to 16(b) interpretation to the point of general acceptance by several major circuits continues to have pivotal importance with respect to the interpretation of 16(b). It should also be noted that in dealing with option agreements to buy or sell equity securities registered under section 12, the courts have experienced similar difficulties in interpreting 16(b) and have attempted to use the pragmatic method of interpretation. In these cases, however, the courts have tended to devote less attention to the broad principles of interpretation and more to analysis of the particular facts of the case. Hence, these cases reflect a degree of uncertainty on the part of the courts in handling the pragmatic method of interpretation in novel and unusual situations.\(^4\) It is clear,

\(^{40}\) \textit{Id.} at 519.

\(^{41}\) \text{367 F.2d 528 (8th Cir. 1966), cert. denied,} 385 U.S. 1006 (1967).

\(^{42}\) \textit{Id.} at 535-36. It is interesting to note that Judge (now Mr. Justice) Blackmun dissented vigorously. \textit{See id.} at 538.

\(^{43}\) 17 C.F.R. § 240.16b-9 (1970); \textit{see also} Hamilton, \textit{supra} note 22.

\(^{44}\) \textit{See, e.g.,} Miller \textit{v. General Outdoor Advertising Co.,} 337 F.2d 944 (2d Cir. 1964);
however, that in these cases the courts have accepted the general principle of a more pragmatic interpretation of section 16(b).

In most of the foregoing cases, the courts were deciding whether the particular transaction presented fell within 16(b). In these cases, the court's use of the pragmatic interpretation enabled them to avoid senseless harshness in transactions which did not reasonably lend themselves to the abuses 16(b) was designed to prevent. Thus, in these cases the pragmatic approach tended to relieve some defendants of 16(b) liability. In contrast to this line of cases, the most significant contribution to the development of the pragmatic method may have come from the opposite direction.

Based upon the suggestion of Judge Hand's concurring opinion in Rattner, Lehman Brothers, a partnership, was again sued as a director under 16(b) on the basis of the deputization theory in Blau v. Lehman. Thomas, a member of the partnership, had been a member of the board of directors of Tide Water Associated Oil Company during a period in which Lehman Brothers had realized short-swing profits in Tide Water stock. In a suit under 16(b) against both Lehman Brothers and Thomas, one of the key issues was whether the partnership itself should be deemed a "director" of Tide Water for 16(b) purposes. Based on fact-findings in the trial court, which had been affirmed by the Second Circuit, that "there was no evidence that the firm of Lehman Brothers deputed Thomas to represent its interests as Director on the board of Tide Water," the United States Supreme Court held that Lehman Brothers was not a "director" within section 16(b). However, the Court stated:

No doubt Lehman Brothers, though a partnership, could for purposes of Section 16 be a "director" of Tide Water and function through a deputy, since Section 3(a)(9) of the Act provides that "'person' means . . . partnership" and Section 3(a)(7) that "'director' means any director of a corporation or any person performing similar functions with respect to any organization, whether incorporated or unincorporated." Consequently Lehman Brothers would be a "director" of Tide Water, if as petitioner's complaint charged Lehman actually functioned as a director through Thomas, who had been deputized by Lehman to perform a director's duties not for himself but for Lehman.
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Thus, without expressly adopting the broad statements of the pragmatic method found in many of the cases discussed above, the Court has, in effect, recognized a pragmatic method of expanding section 16(b) to reach parties not normally thought to be within its scope, where necessary to achieve the purposes of the section. While the Court did not go as far in this direction as it was urged to, there is in its decision a distinct departure from the strictly objective, literal method of interpretation found in the earlier cases.

Although not relied upon in any of the decisions in which the pragmatic method of interpretation was being developed, it is significant that this development was being reinforced by contemporaneous developments in parallel areas of the law. Among other things, the 1964 amendments to the securities acts substantially enlarged the base upon which section 16(b) operates. The addition of section 12(g) to the Exchange Act increased greatly the number of corporations subject to section 12 and the number of insiders subject to section 16. As a result, injustice or harshness in the interpretation of 16(b) must today affect a much larger number of persons and transactions than before. Moreover, there have been the explosive judicial developments under rule 10b-5. This widely noted and analyzed development has become a major aspect of the contemporary law of insider responsibility with respect to corporate information and to transactions in the corporation’s securities. Thus, it is no longer true that 16(b) stands as the exclusive federal remedy to prevent the abuse by insiders of corporate position and information. If the courts in the early cases felt the need to expand 16(b) to its limits because little else was

48 The SEC as amicus curiae and Mr. Justice Douglas urged the Court to hold Lehman Brothers subject to section 16(b) on policy grounds due to their potential access to inside information. See id. at 414-20 (dissenting opinion).

49 See also Marquette Cement Mfg. Co. v. Andreas, 239 F. Supp. 962 (S.D.N.Y. 1965) (deputization recognized as a possibility, but not found to exist in fact).

50 See Lowenfels, supra note 2.


53 Since 1966, section 12(g) has required every corporation which has total assets exceeding $1,000,000 and a class of equity security held of record by 500 or more persons (subject to a limited number of exemptions) to register such security with the SEC. Prior to the 1964 amendments, only companies with securities listed for trading on a national securities exchange were subject to sections 12 and 16. The number of corporations brought under section 16 by the addition of section 12(g) is substantial.

54 See generally A. Bromberg, Securities Law: Fraud—SEC Rule 10b-5 (1967); 3 Loss 1448-74, 1763-97; W. Painter, supra note 21, at 97-316. There are innumerable excellent articles on the many aspects of the rule and the case law development. Undoubtedly, the major decision to date in this area relating to insiders and the access to undisclosed corporate information is SEC v. Texas Gulf Sulphur Co., 401 F.2d 893 (2d Cir. 1968), cert. denied, 394 U.S. 976 (1969).
available to redress insider abuse of corporate information, they need no longer feel that necessity, and a more reasonable interpretation of the section is in order. Adding further support to this conclusion are important new developments in parallel areas of state law.55

RECENT APPLICATIONS OF THE PRAGMATIC INTERPRETATION OF SECTION 16(b) AND THE PROBLEM OF PREDICTABILITY

Although most of the circuits which have considered the question have accepted the idea of a more pragmatic method of interpreting section 16(b), this has not ended the problems, as demonstrated by four of the more recent decisions. These cases have also made it clear that the pragmatic method works both ways. While some, who appear to fall within the literal ambit of 16(b) may be excused because, to hold them would not further the true purposes of the section, others, who appear to be literally outside its reach, may be brought within it by the same method of interpretation for similar reasons.

Three years after its decision in Lamb, the Second Circuit decided Feder v. Martin Marietta Corp.,56 in which the central issue was whether Martin Marietta Corporation could be considered a director of Sperry Rand Corporation for 16(b) purposes on the basis of deputization. George M. Bunker, the president and chief executive officer of Martin Marietta, had served as a director of Sperry Rand from April 29 to August 1, 1963 when he resigned. During this time, Martin Marietta had purchased 101,300 shares of Sperry Rand stock which it sold between August 29 and September 6, 1963 following Bunker’s resignation but less than six months after its purchase. The plaintiff contended that Bunker had represented Martin Marietta when he served as a member of the Sperry Rand board and that Martin Marietta, therefore, was a “director” of Sperry Rand within 16(b) during that time. The trial court agreed that the deputization theory was valid under Blau v. Lehman, thus accepting a pragmatic interpretation, but held on conflicting evidence, that Bunker had not in fact been deputized by Martin Marietta.57

The Second Circuit agreed as to the validity of the deputization theory and the pragmatic method of interpreting 16(b), stating that

[t]he judicial tendency, especially in this circuit, has been to interpret Section 16(b) in ways that are most consistent with the

legislative purpose, even departing where necessary from the literal statutory language. . . . But the policy underlying the enactment of Section 16(b) does not permit an expansion of the statute's scope to persons other than directors, officers, and 10% shareholders. 68

However, the court disagreed as to the interpretation of the conflicting evidence in this case, and reversed, holding that Bunker had in fact been the deputy or representative of Martin Marietta on the Sperry Rand board, and that Martin Marietta was, therefore, a "director" within the meaning of section 16(b). 59 Furthermore, the liability was held to extend to transactions completed by the sales after Bunker's resignation, which were within less than six months of the purchases during his directorship. 60

While this case is quite significant as the first 16(b) case actually finding deputization to exist in fact, it is significant for present purposes for two other reasons. First, it has used the pragmatic interpretation to determine whether the defendant is an insider for 16(b) purposes, whereas most earlier pragmatic cases were concerned with whether the transaction in question fell within the purposes of the section. Second, the pragmatic interpretation is used in this case to enlarge rather than to restrict, the scope of liability to further the purposes of 16(b). On both of these questions, this case lends important support to the wider acceptance and use of the pragmatic method and is consistent with the policy expressed in the earlier pragmatic cases.

Slightly more than a year later, the Second Circuit decided Newmark v. RKO General, Inc. 61 which grew out of a 1967 corporate acquisition. RKO General controlled Frontier Airlines through ownership of 56 percent of its outstanding common stock. In April 1967, the management of Frontier and that of Central Airlines reached a provisional agreement for merger of the two companies. On May 3 or 4, 1967, RKO General contracted conditionally with several large Central Airline shareholders to purchase a majority interest in Central stock at $8.50 per share. The following day, the proposed merger of Central into Frontier was publicly announced. Several contingencies precedent to the consummation of both the merger and the stock purchase agreement were satisfied between May and September 1967. On September 18, 1967, the stock purchase agreement was consummated and the

68 406 F.2d at 262.
69 Id. at 263-66. The court of appeals necessarily held that the district court's determination of the fact issue was clearly erroneous under Fed. R. Civ. P. 52(a).
60 406 F.2d at 266-69.
merger agreement, previously approved by a majority of the shareholders of Central and Frontier, was filed. The issuance and exchange of Frontier stock for the outstanding Central stock pursuant to the terms of the merger occurred on October 1.

On behalf of Central Airlines, the plaintiff contended that RKO General became an owner of more than 10 percent of the equity securities of Central under the May purchase agreement, and that the exchange of these Central shares for Frontier shares through the merger within less than six months constituted a "sale" within the meaning of section 16(b). The court of appeals, affirming the lower court, held for the plaintiff on all issues. With respect to the interpretation of 16(b) the court observed:

The phrase [describing the section as "a crude rule of thumb"] now serves to describe not only the statute but also one approach to its application. Under the "objective" or "rule of thumb" approach, the statute is applied to all transactions which seem to fall within its terms, without regard to whether the imposition of liability would further the purposes of the statute. . . . We have rejected this interpretation . . . in favor of the more "pragmatic" approach of applying the statute only to those situations subject to speculative manipulation.62

The court then held that "[t]he threshold issue raised on this appeal is whether the purchase and subsequent exchange of Central shares lent itself to the type of speculative abuse which section 16(b) was designed to prevent."63 On the facts before it, the court commented that the contract to purchase Central stock was "a classic example of trading while in the possession of information unavailable to the general public" and that "RKO was in an ideal position to take speculative advantage" of the subsequent rise in the market price of Central stock.64 The court, based on its analysis of the transaction, therefore concluded that

the purchase and subsequent exchange of Central shares were fraught with the opportunities for the kind of speculative abuse section 16(b) was intended to abort. RKO's success in fixing the purchase price before the proposed merger became public knowledge opened the door to possible speculative gains. Its ability to determine whether and when the merger would be consummated enabled it to maximize these gains or, at the very least, to avoid any loss.65

62 Id. at 351 n.2.
63 Id. at 353.
64 Id.
65 Id. at 354.
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Having thus answered the threshold question, the court held that the exchange of the Central shares through the merger constituted a "sale" for 16(b) purposes, notwithstanding RKO's vigorous contention that its relative ownership position in the overall business enterprise was the same before and after the merger and was therefore unaffected by the merger, and that the exchange in the merger came within the doctrine of economic equivalence announced in *Lamb*. The court also affirmed the decision by the lower court adding 15 percent to the recovery representing the control premium which had been realized by RKO. In both of these holdings, the court relied heavily on the fact that the exchange of shares in the merger involved stock in *two different corporations*, despite the fact that they were two parts of the same overall enterprise controlled by RKO General, rather than two economically equivalent classes of stock in the *same corporation*, as was the case in *Lamb*.

Whether the court has correctly interpreted the applicability of *Lamb* is debatable. On the one hand, the case represents the most express effort to date to utilize the pragmatic interpretation in a very different factual context. On the other hand, the court seems to have rejected the application of economic equivalence to the facts in this case on the strength of a highly formalistic distinction, which more nearly resembles the reasoning and results in cases using the traditional objective method of interpretation.

In a different context, the Seventh Circuit recently made effective use of the pragmatic method of interpretation to impose 16(b) liability in *Bershad v. McDonough*. The defendants, husband and wife, on March 15 and 16, 1967, purchased at $6.75 per share more than 10 percent of the common stock of Cudahy Company, which was registered under section 12. On July 20, 1967, the defendants entered into a formal option agreement with Smelting Refining and Mining Company, which granted Smelting the right to purchase the bulk of the defendants' stock in Cudahy on or before October 1, 1967, at $9.00 per share. Smelting paid the defendants $350,000 for the option, which was to be applied against the purchase price, if the option was exercised. Smelting was also granted an irrevocable proxy to vote the stock subject to the option until October 1, 1967. On July 25, 1967, its representatives were substituted for the defendants as members of the Cudahy board of directors. The option was exercised and the sale of defendants' stock to Smelting was closed in late September 1967, slightly more than six months after defendants' purchase.

*66* 428 F.2d 693 (7th Cir. 1970).
The court of appeals, affirming a summary judgment for the plaintiff, held that for 16(b) purposes, the option granted to Smelting in July 1967, and the circumstances surrounding it constituted a “sale” of the defendants' stock at that time and within less than six months after their purchases in March 1967. The argument that the option did not constitute a sale under West Virginia law until it was exercised was rejected by the court:

[U]nder Section 3(a)(14) of the Act . . . the “sales” covered by Section 16(b) are broadly defined to include “any contract to sell or otherwise dispose of” any security. . . . Construction of these terms is a matter of federal law . . . and “[w]hatever the terms ‘purchase’ and ‘sale’ may mean in other contexts,” they should be construed in a manner which will effectuate the purposes of the specific section of the Act in which they are used. SEC v. National Securities, Inc., 393 U.S. 453, 467. . . . Applying this touchstone, courts have generally concluded that a transaction falls within the ambit of Section 16(b) if it can reasonably be characterized as a “purchase” or “sale” without doing violence to the language of the statute, and if the transaction is of a kind which can possibly lend itself to the speculation encompassed by Section 16(b). . . . The phrase “any purchase and sale” in Section 16(b) is therefore not to be limited or defined solely in terms of commercial law of sales and notions of contractual rights and duties. [67]

The court also observed that in this case the option to Smelting was ultimately exercised and had been obtained by a substantial advance payment, and that Smelting had obtained irrevocable proxies and representation on the board of directors at the time the option was granted. Hence, the circumstances surrounding the granting of the option indicated that its later exercise was, in fact, a foregone conclusion.

In this case, the court has again used the pragmatic interpretation to enlarge rather than to reduce the apparent scope of liability in order to prevent circumvention of the purposes of 16(b). On the facts presented by the case, the court's use of the pragmatic method appears substantially consistent with the section's purposes. The troublesome fact that the option in question was apparently that of the purchaser and not that of the defendant, which would seem to militate against the result reached, is apparently satisfied by the court's factual determination that the exercise of the option was all but certain from the time it was granted.

A similar but more complex set of facts was involved in Abrams [67 Id. at 696-97.]
v. Occidental Petroleum Corp., which grew out of the competitive efforts of two corporations to acquire the Kern County Land Company. In early 1967, Occidental sought a merger with Kern but was rebuffed. On May 10, 1967, Occidental, through a tender offer, acquired more than 10 percent of the outstanding Kern stock to strengthen its case for a merger. As a defensive tactic, however, Kern promptly negotiated a merger agreement with a subsidiary of Tenneco. Consequently, on June 2, 1967, Occidental entered into an agreement with the Tenneco subsidiary under which Occidental granted the subsidiary an option to purchase the Tenneco preference stock which Occidental would receive in the proposed merger as a shareholder in Kern. Although less than clear from the opinion, the option was apparently that of Tenneco. However, its exercise by Tenneco may have been assumed from the outset. On July 17, 1967, the Kern shareholders approved the proposed merger without dissent from Occidental, and on August 30, 1967, the merger was consummated and the Tenneco preference stock issued. Occidental made several unsuccessful attempts to delay the merger until six months after its purchases of Kern stock. It deferred the exchange of its Kern stock for the Tenneco preference stock until December 11, 1967, at which time it immediately closed under the option agreement with Tenneco.

In a consolidation of four actions under section 16(b) against Occidental, the Southern District Court of New York held for the plaintiffs, apparently basing its decision on the pragmatic method of interpretation. In an early fact-finding, the court stated that

at least [two] alternatives [available to Occidental] . . . would present the possibility for speculative abuse by Occidental of its position in Old Kern, as that term is understood within the purview and intendment of Section 16(b). Apart from the abuse of inside information, which is presumed to exist under the statute, the possibilities of abuse in the factual context of this case can readily be envisaged. For example, Occidental could have used inside information to enable it to decide whether or not to fight the merger or sell its stock. Indeed Occidental elected to enter into the option agreement.

Although the opinion is vague in some respects as to its interpretation of 16(b) in this situation, the court holds, in effect, that the option agreement on June 2 and the consummation of the merger on August

69 Id. at 90,273.
resulted in a 16(b) "sale" of the Kern stock acquired by Occidental in May at the price established in the option agreement. It is not entirely clear whether the court is holding that the Kern stock was sold in the August 30 merger at a price established in the June 2 option, or is holding that the stock purchased in May was disposed of on June 2, on the theory that the Tenneco preference stock was the economic equivalent of the Kern stock and that the purchase of one stock and the sale of its economic equivalent within less than six months falls under 16(b). In either event, the court was not deterred from imposing 16(b) liability because the closing under the option agreement was delayed until December—more than six months after the purchases.

ANALYSIS

The transition in the methods used by the courts in interpreting the provisions of section 16(b) leaves three basic questions, which should be considered at this point: (1) Is the pragmatic method of interpreting 16(b) justified, or should the courts be urged to return to the traditional objective method of interpretation? (2) If the pragmatic method of interpretation is accepted, what is the basic purpose and intent of section 16(b), by which the courts should be guided in deciding cases under the pragmatic method of interpretation? (3) Should the pragmatic method of interpretation be used by the courts in dealing with all of the issues presented by 16(b), or should it be limited to the types of issues to which it has previously been applied?

With respect to the first question, it is submitted that, despite the increased risk of unpredictability in 16(b) cases, the pragmatic method of interpretation is preferable in principle to the objective method originally adopted by the courts. The pragmatic method obviously allows a court greater flexibility to interpret in a particular situation to achieve a maximum degree of both justness in result and fulfillment of the policy underlying section 16(b). This, of course, is what creates greater unpredictability in outcome. However, it also allows courts to avoid the arbitrariness and purposeless harshness in particular cases, which has frequently been associated with decisions under the objective method of interpretation. On the other hand, the pragmatic method also gives the courts greater flexibility to include within 16(b)'s reach a variety of situations which actually come within its purposes, but, which are structured to allow technical arguments to the effect that they do not fall within its literal provisions. The best illustrations of this use of the pragmatic method are
the cases which have developed the deputization theory and those which deal with option agreements allowing an insider to freeze short-swing profits without actually completing a sale within less than six months of the purchase.

In addition, the pragmatic method of interpreting section 16(b) guided by its essential purpose has also received the implicit support of the Supreme Court in *Blau v. Lehman*, although the Court did not comment directly on the method of interpretation. The legislative history of the section is not conclusive in favor of either the objective or the pragmatic method of interpretation, but lends adequate support to the policy-guided pragmatic method to prevent the objective method from being regarded as mandated by Congress. It seems clear that the now famous "crude rule of thumb" description by Mr. Corcoran expressly referred only to the fact that 16(b) explicitly eliminated any requirement that the plaintiff prove the subjective intent of the insider to engage in a short-swing transaction. To relieve the plaintiff of this burden of proof is understandably necessary to the efficiency of suits under 16(b). But this does not require — nor apparently did Mr. Corcoran regard it as requiring — that courts should give no consideration to the policies or purposes of section 16(b) or to the type of transactions it was actually intended to deal with. Hence, the objective method of interpretation adopted originally by the courts in part on the strength of the "crude rule of thumb" description was probably an exaggeration of Mr. Corcoran's intent.

Finally, it is also significant that the courts in the early cases were faced with fairly clear short-swing speculation by corporate insiders of the sort intended to be covered by 16(b). It was not until later that the courts began to be faced with the more difficult interpretive issues in less obvious cases. Hence, the pragmatic method of interpretation, which has apparently been accepted in most of the recent cases and particularly in the Second Circuit, should no longer be regarded as suspect because of the strong language in the original decisions supporting the objective method. On the contrary, the pragmatic method should now be regarded as the leading and most legitimate method of interpretation.

This conclusion, however, leads to consideration of the second basic question outlined above. If the courts are to be guided by the policy and purpose of 16(b) in interpreting its scope, a clear and pre-

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cise definition of the policy and purpose of the section is essential. Too frequently the cases adopting the pragmatic method have given scant attention to this problem. Instead, they have typically left the question with broad, inconclusive statements that 16(b) is to be interpreted to include within its provisions every transaction which "is of a kind which can possibly lend itself to the speculation encompassed by section 16(b)," or which "in any way . . . lends itself to the accomplishment of what the statute is designed to prevent." In part, the unpredictability which has resulted from the use of the pragmatic method in several of the recent cases is attributable to the fact that the courts have been satisfied with very general conclusory statements of this sort, without adequately determining exactly what the intended purpose and scope of the section is.

The necessity for determining this working principle of the pragmatic interpretation was clearly recognized by the Ninth Circuit in the Max Factor case, where the court stated:

The initial inquiry must therefore be: What is the purpose of Section 16(b)—what practices is the statute designed to prevent?

As Section 16(b) itself states, its general purpose is to preclude the "unfair use of information which may have been obtained by" corporate insiders, in trading in the securities of their corporation. But Congress did not seek to accomplish the whole of this purpose by Section 16(b) alone. Section 16(b) creates a special remedy, applicable only in a limited situation. Absolute liability is imposed, but only when the insider both acquires and disposes of securities of his corporation "within any period of less than six months." When acquisition and disposition are separated by a longer period Section 16(b) is inapplicable; other remedies are then available, but only upon proof of actual wrongdoing.

The fact that Section 16(b) was intended to apply only to insider "short-term speculative swings" is confirmed by legislative history, and has been often remarked by the courts.

The reasons which lead Congress to declare insider profits on stock transactions forfeit only when purchase and sale both occurred within less than six months, though not spelled out in the legislative materials, are nonetheless clear. Improper use of insider information by corporate insiders is most likely to occur in short-term, in-and-out trading. The temptation to trade upon inside information is enhanced when the period for which the capital must be committed is short. And ordinarily the useful life of "confidential" inside information is brief. The evidence upon which Con-

72 Blau v. Lehman, 286 F.2d 786, 792 (2d Cir. 1960), aff'd, 368 U.S. 403 (1962).
gress acted indicated that the abuse occurred almost entirely in short-swing transactions. Moreover, few if any reasons could be advanced for encouraging such trading by insiders. On the other hand, in long-term investment the risk of abuse of inside information was relatively slight, and the affirmative value of long-term personal financial commitments by insiders to the prosperity of the companies which they controlled was obviously great. Thus, by basing forfeiture of profits upon the length of the insider's investment commitment, Congress sought to minimize misuse of confidential information without unduly discouraging bona fide long-term investment.\footnote{342 F.2d at 307-08 (emphasis added).}

The court’s analysis is eminently correct in two important respects. First, the court has clearly recognized the necessity for determining this issue, in order to use the pragmatic method of interpretation intelligently. Second, the court has, it is submitted, correctly determined the basic purposes underlying 16(b) and the types of practices which were intended by the draftsmen to be prevented by it. The court’s conclusion that the section was intended to create a special remedy applicable only with respect to certain insider transactions and was not intended to provide a general remedy for all insider abuses is both reasonable and consistent with legislative history.\footnote{Short-swing speculative market activity by insiders was the principal abuse considered by Congress with regard to section 16. Among the most vicious practices unearthed at the hearings before the subcommittee was the flagrant betrayal of their fiduciary duties by directors and officers of corporations who used their positions of trust and the confidential information which came to them in such positions, to aid them in their market activities. Closely allied to this type of abuse was the unscrupulous employment of inside information by large stockholders who, while not directors and officers, exercised sufficient control over the destinies of the companies to enable them to acquire and profit by information not available to others. S. REP. No. 1455, 73d Cong., 2d Sess. 55 (1934). Section 16 of the Exchange Act was drafted to remedy these abuses. The bill further aims to protect the interests of the public by preventing directors, officers and principal stockholders of a corporation, the stock of which is traded in on exchanges from speculating in the stock on the basis of information not available to others. Any change in the holdings of such insiders must be reported to the Commission, and profits realized from the purchase and sale, or the sale and purchase of an equity security within a period of less than 6 months are recoverable by the corporation. Such a provision will render difficult or impossible the kinds of transactions which were frequently described to the committee, where directors and large stockholders participated in pools trading in the stock of their own companies, with the benefit of advance information regarding an increase or resumption of dividends in some cases, and the passing of dividends in others. S. REP. No. 792, 73d Cong., 2d Sess. 9 (1934). That the scope of the 16(b) remedy should be related to in-and-out trading activity has been indicated by several leading authors. See 2 Loss 1059; Hamilton, supra note 22, at 1455-58, 1488-95; Feldman & Rubin, Statutory Inhibitions Upon Unfair Use of Corporate Information by Insiders, 95 U. Pa. L. REV. 468, 486 (1947).}

Under this analysis, the type of insider transaction intended to be
covered by section 16(b) is essentially an *in-and-out trading* transaction in which the insider both acquires and disposes of the securities in question within less than six months, usually through purchases and sales in the public securities markets. Hence, any transaction by an insider which amounts to short-swing *in-and-out trading* activity should be interpreted as coming within the section, but any transaction which does not have the effect of achieving this type of *in-and-out trading* should be interpreted as being beyond the purposes and scope of 16(b). If the courts will adopt this in-and-out trading interpretation of the purpose and intended scope of the section as the principle underlying the pragmatic method of interpretation, they should experience relatively less difficulty in interpreting 16(b) in future cases and there should also be a significantly greater degree of predictability in the decisions.

This interpretation, limiting the scope of 16(b) to speculative trading transactions, has been recognized to an extent in many of the cases using the pragmatic method. But frequently the cases have failed to be specific concerning the type of speculative transactions intended to be covered by the section.\(^7\) The conclusion that 16(b) was intended to deal only with a specific type of insider abuse which gave the insider an unfair advantage in trading in the public securities markets and was not intended to remedy all abuses by insiders is further reinforced by the fact that Congress in sections 9 and 10 of the Exchange Act dealt separately and comprehensively with deceptive and manipulative activity,\(^6\) and the fact that in other parts of section 16 Congress related the scope of this specific section to speculative market trading activity by insiders in the equity securities of their corporations. Both the filing requirements in section 16(a) to disclose changes in ownership and the limitations in 16(c) on certain types of trading activities tend to relate primarily to speculative market activity of a short-term nature.

Further support for the courts to adopt this approach to the interpretation of 16(b) is supplied by the important developments in the past decade under rule 10b-5 and the state law relating to corporate insiders. It is quite clear today that the courts have found adequate

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\(^7\) See, e.g., Bershad v. McDonough, 428 F.2d 693 (7th Cir. 1970); Petteys v. Butler, 367 F.2d 528 (8th Cir. 1966), cert. denied, 385 U.S. 1005 (1967); Blau v. Lamb, 363 F.2d 507 (2d Cir. 1966), cert. denied, 385 U.S. 1002 (1967); Ferraiolo v. Newman, 259 F.2d 342 (6th Cir. 1958), cert. denied, 359 U.S. 927 (1959); Roberts v. Eaton, 212 F.2d 82 (2d Cir.), cert. denied, 348 U.S. 827 (1954). In each of these cases, the court recognizes that 16(b) is intended to reach only profits by insiders from *short-swing speculation*. But the courts do not further define this as *in-and-out trading* or equivalent market activity.

means in these resources to redress most insider abuses — particularly those relating to abuse of corporate information. Hence, if the courts in the early 16(b) cases felt impelled to construe it as broadly as possible because there was little else in the law to prevent insider abuse of corporate information, they should no longer feel that necessity.

Finally, the third basic question outlined above should be considered. To what extent should the pragmatic method of interpreting 16(b), guided by the principle that the section is intended to relate only to in-and-out trading activity by insiders, be used to interpret all of the issues which may arise? Many of the cases which developed the pragmatic interpretation concerned only whether particular transactions came within the section's scope. It is submitted, however, that the pragmatic method of interpretation should also apply to other issues under 16(b), provided that this does not operate to complicate the plaintiff's case unreasonably or to diminish the efficiency of the remedy in proper cases. The deputization cases have demonstrated that a more flexible method of interpretation can be effectively used to bring within the short-swing profit recovery provisions those who actually have the benefit of representation on the board of directors of the corporate issuer. Similarly, transactions involving options created within, but performed beyond the six-month period have been effectively brought within 16(b) through the pragmatic interpretation, where necessary to achieve the section's purposes. On the other hand, 16(b) expressly provides that it applies "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." Thus, the pragmatic method of interpretation clearly may not be used to inject into the case any issue of the insider's subjective intent to engage in a short-swing trading transaction.

There remain two possible issues under 16(b) to which the pragmatic method of interpretation might be applied, but as yet has not been. There is first the question of whether the courts should allow the injection in 16(b) cases of any issue as to the defendant's actual possession or use of inside information. It has been vigorously argued that this should be allowed, at least as a defensive issue to the limited extent of permitting the insider to prove that he was totally without any inside information at the time of the transactions in question. However, this would probably introduce substantial com-

77 See Munter, supra note 11.
lications in the disposition of cases and might thus impede the efficiency of the 16(b) remedy, inconsistently with the apparent legislative intent.\textsuperscript{78} Second, the method for determining "profit realized" for 16(b) purposes, adopted in \textit{Smolowe} and \textit{Gratz} and which has been followed in innumerable subsequent cases, has long been considered excessively harsh and has not yet been reconsidered under the pragmatic method of interpretation. Under this method of determining profit realized, it is entirely possible that the defendant may have realized actual losses in the trading in question but still be liable to the issuer under 16(b) for a profit. Indeed, this occurred in \textit{Gratz},\textsuperscript{79} and it is submitted that this is not necessary to achieve the true purposes of the section.

The origin of this method of determining profit realized is found in \textit{Smolowe} where the court applied the concept that securities of the same class are fungible in order to squeeze all possible profits out of short-swing speculative trading. In doing this, the court rejected three alternative methods of matching sales and purchases, which were based on accounting and tax principles. Since the specific term used in 16(b) is not profit but "profit realized," the three alternative approaches urged by the defendants were properly rejected by the court. For the purposes of short-swing speculative trading, shares of the same class of stock are indeed fungible. In order to deny corporate insiders short-swing speculative profits, it is appropriate to match sales and purchases without regard to the identification certificates, average values or the rule of first in, first out. However, the term "profit realized" used in 16(b) should permit the interpretation that losses actually \textit{realized} by the insider during the period in question should also be taken into consideration to reduce the profit realized which is recoverable by the corporation. This approach must be distinguished from other concepts which have been suggested in the cases which would allow the defendant to diminish his liability on the basis of \textit{accrued but unrealized} losses. The method suggested here would allow the defendant, by affirmative pleading and proof, to diminish his liability only to the extent that he has actually \textit{realized} losses within the period of the transactions giving rise to 16(b) liability. This would allow the corporation to recover only the net profit actually realized by the insider, but this amount would be determined by matching the lowest purchase price with the highest sale price as the courts have traditionally done.

\textsuperscript{78} See note 10 \textit{supra}, reflecting the negative attitude of the draftsmen toward similar issues. \textit{Cf.} Smolowe v. Delendo Corp., 136 F.2d 231 (2d Cir.), \textit{cert. denied}, 320 U.S. 751 (1943); 2 Loss 1040-44.

\textsuperscript{79} See note 18 \textit{supra}. 
NEED FOR CLARIFICATION

The four recent cases using the pragmatic interpretation discussed above should be considered briefly in the light of these suggested principles of interpretation to determine whether the court in each case has correctly discerned the essential purposes of 16(b) as applied to the facts before the court. Under this approach, the decision in *Feder* appears to be correct in its method of interpreting the section, although there is obvious room for disagreement as to the inferences to be drawn from the evidence in the case. In accepting and applying the proposition that one corporation may be found to be a "director" of another corporation for the purposes of 16(b) through deputization, the court is effectively furthering the policies underlying the section. The trading activity of the defendant Sperry Rand was clearly in-and-out market trading within less than six months, while its chief executive officer sat on the board of directors of Martin Marietta. Thus, to construe 16(b) as including this insider in a transaction clearly of the nature intended to be covered by the section is a successful use of the pragmatic method of interpretation.

Similarly, the court in *Bershad*, in looking through the form of the option transaction to determine that its substantive effect was to enable the defendants to establish a fixed sale price within less than six months of their purchase, although the option was not actually exercised or closed until later, has effectively used the pragmatic interpretation to reach a transaction essentially within its purposes. Unfortunately, the opinion in *Abrams* is not sufficiently clear to permit an adequate evaluation. If the court is willing to look through the form of the option transaction to determine that the date it was granted is to be treated as the date of the defendant's sale, (if this is the court's intent, and if the court is construing the option as certain to be exercised from the outset), or is willing to match the purchase of one security and the sale of an economically equivalent security for 16(b) purposes, (if this is what the court has done), this may be an effective use of the pragmatic method of interpretation. If, however, neither is the case, and the court is in fact giving exaggerated emphasis to the effect of the merger, its interpretation of 16(b) in this transaction is more questionable.

It is submitted, however, that the court in *Newmark* has incorrectly interpreted the applicability of 16(b) to the facts there presented. If the essential purpose of the section is interpreted as relating to short-swing *in-and-out trading* transactions by insiders which give rise to speculative profits, it is clear that the transaction in the *Newmark* case is entirely beyond the scope of section 16(b). In its determination
of the "threshold question," the court has apparently concluded that
the purpose of the section is to redress every exercise of corporate con-
trol and any use of corporate information by an insider. It appears
that the merger itself, which the court necessarily treats as a "sale" for
16(b) purposes, did not actually result in any net change in RKO
General's ownership of the entire organization. A controlling majority
interest in one subsidiary was exchanged through the merger for
stock in another majority owned and controlled subsidiary which
the defendant continued to hold.

This clearly does not amount to a trading transaction within the
purpose and scope of 16(b). Thus, to apply the section to this trans-
action more nearly resembles an objective or literal interpretation of
its provisions than an effective use of the pragmatic method. Finally,
the court's willingness to add an additional 15 percent to the profits
recoverable as a control premium is obscure. Obviously, RKO General
was in control of the two corporations both before and after the merger.
However, it neither increased nor decreased its effective control, nor
realized any benefit from the sale of control, in the merger transaction.
The basis for adding this control premium to the profit realized by
RKO in the merger is therefore, unclear. For these reasons it appears
that Newmark represents an ostensible but incorrect use of the prag-
matic method of interpretation.

CONCLUSION

The pragmatic method of interpretation of section 16(b) has be-
come generally accepted, but, its underlying principles have not been
articulated with adequate precision to avoid confusion in the cases.
Most cases adopting the pragmatic method of interpretation have been
clear to the effect that 16(b) should be interpreted in the light of its
purposes; but, the cases have not been equally clear in discerning the
specific purposes intended to be served by the section. Thus, there has
been increased unpredictability in the decisions.

It seems clear that the essential purpose intended to be achieved
in section 16(b) was to prevent insiders from realizing speculative
profits through short-swing trading transactions in the equity securities
of their corporations with the unfair advantage of access to inside corpo-
rate information. This had been a substantial abuse prior to the enact-
ment of the section and was clearly in the minds of the draftsmen. The
purpose and scope of 16(b) should therefore be interpreted as involving
only this sort of short-swing in-and-out trading transaction and not
other types of transactions by insiders. This analysis of 16(b)'s pur-
pose was best articulated by the Ninth Circuit in the *Max Factor* case. If this principle is accepted as the rationale, the pragmatic method of interpreting 16(b) can be more effectively used by the courts in a variety of contexts with relatively greater predictability. Other types of abuses by insiders can be better dealt with under the many other aspects of the contemporary law relating to corporate insiders — particularly those evolving under rule 10b-5.