CASE NOTES

SECURITIES LAW — INSIDER TRADING — BENEFICIAL OWNER MAY USE SPLIT-SALE TECHNIQUE TO REDUCE SHORT-SWING PROFIT LIABILITY AS AN INSIDER UNDER SECTION 16(b) OF THE SECURITIES EXCHANGE ACT OF 1934 — *Reliance Electric Co. v. Emerson Electric Co.* — 92 S. Ct. 596 (1972).

During 1966 the Emerson Electric Company, respondent, negotiated with the Dodge Manufacturing Company concerning a possible merger. Later that year, Dodge notified Emerson that its board of directors had rejected Emerson's merger proposal. Undeterred, Emerson responded in May of 1967 with a cash tender offer to the Dodge shareholders, offering to purchase up to 550,000 shares of Dodge common stock at $63 per share.[1] Dodge defended by announcing plans to merge with the petitioner, Reliance Electric Company.[2]

Emerson had acquired 152,282 shares by the end of June — 13.2% of the outstanding stock in Dodge. By the end of August the Dodge-Reliance merger had progressed to readiness for final approval by the Dodge board of directors, and was all but certain to defeat Emerson's take-over bid. Rather than exchange the tendered shares for stock in the new Reliance Electric Company, Emerson decided to sell them. In an Advice of Counsel letter, Emerson was advised that because its holdings exceeded 10% of the outstanding Dodge common stock, sale or exchange of the Dodge stock could result in liability to the issuer under section 16(b) of the Securities Exchange Act of 1934. Its counsel suggested that the sale be carried out as two separate transactions to minimize any recovery by the issuer under that statute.[3]

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1. Dodge then tried unsuccessfully to get an injunction against Emerson in a federal district court in South Bend, Indiana, to enjoin the latter from accepting tenders of Dodge stock. In denying a preliminary injunction, the court found that Emerson's information came from public sources and that Emerson did not have any "insider" information about Dodge Manufacturing Company. Emerson Elec. Co. v. Reliance Elec. Co., 434 F.2d 918, 920 (8th Cir. 1970).

2. Emerson attempted to get its merger proposal submitted to the Dodge stockholders, but Dodge refused to submit the matter or to provide a shareholder list. Emerson received a judgment in the circuit court of St. Joseph County, Indiana, directing Reliance to produce the list, but was unsuccessful in a suit brought in a federal district court to force Dodge to provide Emerson with access to the Dodge stockholders and to enjoin Dodge "from making false and misleading statements to its shareholders and others about Emerson's merger proposal." Brief for Respondent at 4-5, Reliance Elec. Co. v. Emerson Elec. Co., 92 S.Ct. 596 (1972).

3. *See* Emerson Elec. Co. v. Reliance Elec. Co., 306 F. Supp. 588, 592 (E.D. Mo. 1969).

Acting on this advice, Emerson sold 87,000 shares on August 28th at $68 per share to a brokerage house, reducing its Dodge holdings to 9.96%. On September 11th the remaining 115,282 shares were sold to Dodge at $69 per share. Gross profit on the two sales amounted to over $900,000. Reliance, now merged with Dodge, claimed the entire profit by virtue of the statute.

Emerson brought a declaratory judgment action in federal district court to determine its rights in the profits and Reliance counterclaimed for the entire $900,000. "Looking through form to discern substance," the district court found intent to "avoid the consequences" of section 16(b) and allowed Reliance full recovery.[4] The court stated that even though a series of sales may not be "legally tied," "sale", as contemplated by the section, could cover a series of related transactions by which a beneficial owner disposed of his holdings, if these transactions were executed in accord with a predetermined plan to avoid short-swing liability.[5] Without questioning the good faith of the counsel of Emerson, the court felt that the opinion letter and Emerson's subsequent actions revealed intent to avoid the "consequences" of the section.[6]

The United States Court of Appeals for the Eighth Circuit reversed and remanded,[7] holding that Emerson was liable for its profits only on the first sale because Emerson was a 10% owner at that time and, therefore, within the ambit of section 16(b).[8] The court found that an intentional arrangement of a securities transaction so as to avoid or minimize liability under section 16(b) was somewhat analogous to accepted tax practice, which seeks to structure the taxpayer's activities so as to minimize liability under tax statutes.[9] Noting that no prior case involving the validity of a split-sale had been cited where the sales were not "legally" tied,[10] the court reasoned that the arbitrary standards chosen by Congress for the administration of the statute prohibited judicial inquiry into non-legal, subjective relationships between separate sales. These standards were clear to the court although it noted that the statute was not free of "ambiguity" in its language.[11]

The United States Supreme Court granted certiorari,[12] and the case was heard on November 10th and 11th, 1971.[13] That Court noted

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4. *Id.* at 592-93.
5. *Id.* at 592.
6. *Id.* at 593.
7. Emerson Elec. Co. v. Reliance Elec. Co., 434 F.2d 918 (8th Cir. 1970).
8. *Id.* at 924.
9. *Id.* at 925, citing Gregory v. Helvering, 293 U.S. 465, 469 (1934).
10. *Id.* at 925.
11. *Id.* at 922.
12. Reliance Elec. Co. v. Emerson Elec. Co., 401 U.S. 1008 (1971).
13. Reliance Elec. Co. v. Emerson Elec. Co., 92 S.Ct. 596 (1972).

that experts on securities law have recommended the exact procedure[14] followed by Emerson in situations where a stockholder subject to the section wishes to sell his holdings within six months of purchase, and affirmed the court of appeals. *Reliance Electric Co. v. Emerson Electric Co.*, 92 S. Ct. 596 (1972).

In accepting the validity of this procedure, the Supreme Court stated that the contrary view, urged by the Securities and Exchange Commission as amicus curiae, was undermined by the commission's previous interpretations of the section. Specifically, the Court alluded to the SEC practice of granting exemptions under 16(b) to transactions by stockholders no longer subject to the reporting requirements of section 16(a) by virtue of their falling below 10% ownership at some time during the reporting period. In other words, the Court felt that an exemption from the reporting requirements of 16(a), based on 10% ownership, was also an exemption under the provisions of 16(b) (also based on 10% ownership), and that the SEC's prior treatment of the two sections made the conclusion all the more logical.[15] Justice Stewart, speaking for the majority, emphasized that the statute was an objective one and that its "mechanical quality" would be compromised by searching for subjective connections between separate sales.[16] To construe the section as allowing such judicial inquiry would, the Court argued, be a flat contradiction of the words of the section. The Court indicated that if Congress wished to include such transactions within the statute, the statute should so specify or should be amended.[17]

To prevent the unfair use of inside information in securities transactions, section 16(b) provides that an issuer corporation may compel offending "insiders" to disgorge their profits on stock dealings falling within the scope of the section.[18] An "insider" is any

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14. In an effort to minimize the effects of § 16(b), Loss suggests that: "[A] person who owns 15 percent and wants to sell down to 5 percent should sell 5-plus percent in one transaction and then, after he becomes a holder of slightly less than 10 percent, sell out the remainder." L. Loss, SECURITIES REGULATION, Vol. II, 1060 (2d ed. 1961). And as Seligman explains: "[T]he intention of the language was to exclude the second sale in a case where 10% is purchased, 5% sold within three months, and the remaining 5% a month later. This latter construction of the Act is, it is believed the only safe one to rely upon." Seligman, *Problems Under the Securities Exchange Act*, 21 VA. L. REV. 1, 20 (1934).

15. 92 S.Ct. at 601.

16. *Id.* at 600.

17. *Id.*

18. 15 U.S.C. § 78p(b) (1970) provides:

For the purpose of preventing the unfair use of information which may have been obtained by such beneficial owner, director, or officer by reason of his relationship to the issuer, any profit realized by him from any purchase and sale, or any sale and purchase, of any equity security of such issuer (other than an exempted security) within any period of less than six months, unless such security was acquired in good faith in connection with a debt previously contracted, shall inure to and be recoverable by the the issuer, irrespective of

beneficial owner[19] of more than 10% of the outstanding stock in a registered corporation, or a director or officer of that corporation. To recover the insider's profits, the insider being a 10% beneficial owner, the corporation need only show that the defendant purchased and sold its stock within any six month period, provided that the individual owned more than 10% of any class of its shares "both at the time of the purchase and sale."[20] This 10% limitation is an arbitrary approximation[21] and its effect will not be avoided by a showing that the defendant did not use actual inside information and acted in good faith. Congress might have simply specified "insiders" were to be liable and left it for the courts to determine each case on its own facts. Instead, for reasons to be presented, Congress chose an "objective" standard which does not involve the difficulty of proving the actual misuse of inside information.[22]

The other arbitrary measure is the six-month requirement, often called the "crude rule of thumb."[23] It rests on the assumption that the value of inside information and the need to protect against its unfair use lies primarily in the short-run. Much as the tax law affords relief to investors who hold their investments for an arbitrary six-month period, section 16(b) exempts insiders from liability over the long-run. This exemption bottoms on the theory that the normal forces of the market will put "insiders" on more even terms with smaller stockholders and the investing public if the "insiders" must hold on to their securities for at least six months after purchase.[24]

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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 within sixty days after request or shall fail diligently to prosecute the same thereafter; but no such suit shall be brought more than two years after the date such profit was realized. The 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 securtiy involved, or any transaction or transactions which the Commission by rules and regulations may exempt as not comprehended within the purpose of this subsection.

19. *See* 92 S.Ct. 596 at n. 1.

20. 15 U.S.C. § 78p(b) (1970).

21. Newmark v. RKO Gen. Inc., 425 F.2d 348 (2d Cir. 1970), *cert. denied,* 400 U.S. 854 (1970).

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

23. "You hold the director, irrespective of any intention or expectation to sell the security within six months after, because it will be absolutely impossible to prove the existence of such intention or expectation, and you have this crude rule of thumb . . . . " *Hearings on S. 84 before the Senate Committee on Banking and Currency,* 72d Cong., 2d Sess., at 6557 (1934).

24. Petitioner's Brief for Rehearing at 2, Reliance Elec. Co. v. Emerson Elec. Co., 92 S.Ct. 596 (1972).

If the insider sells securities held for a long period and repurchases them within six months at a lower price, the effect of the statute is the same.

Section 16(b) has been said to have a "prophylactic effect."[25] In the hearings by the Committee on Banking and Currency prior to enactment of the Securities Exchange Act of 1934, testimony was heard concerning the practice of officers, directors, and large stockholders in speculating in their company's shares. It was revealed that many individuals and "pools" of various officers and directors considered their unique position to buy and sell on the basis of information not yet public as one of the emoluments of office. Frequently, such "insiders" would sell their holdings shortly before announcing facts which would produce a decline in the market value of the stock in the corporation, only to repurchase that stock later at a reduced price.[26] So vicious did Congress consider such violation of the fiduciary relationship occupied by officers and directors that it enacted section 16(b) with the intent of removing all "possible profits" from short-term transactions by a specified class of security holders.[27]

In that the Supreme Court sustained Emerson's liability for the profits on the first sale, it would evidently hold Emerson liable for its entire profits if the full 13.2% had been sold in one transaction. In looking to the second sale, the Court found no liability because Emerson was not then a 10% holder. Significantly, the Court noted that the underlying purpose of the statute was to "curb the evils of insider trading" by a "flat rule taking the profits out of a *class of transactions* in which the possibility of abuse was believed to be intolerably great."[28] The issue here, the validity of a split sale, is one of first impression.[29] This transactional approach inherent in the Court's analysis has, however, been the subject of considerable litigation in the federal courts ever since the statute was enacted. The statute announces that its *raison d'etre* is the prevention of "unfair use of information which may have been obtained"[30] by certain designated persons, yet its exemptive provisions contemplate transactions[31] rather than individuals or corporations. In other words, the Gordian knot, which the Court now cuts, has always been the problem of whether the central purpose of section 16(b) is to

25. Bershad v. McDonough, 428 F.2d 693, 696 (7th Cir. 1970).
26. Hearings on S. 84, *supra* note 23.
27. Smolowe v. Delendo Corp., 136 F.2d 231, 239 (2d Cir. 1943), *cert. denied,* 320 U.S. 751 (1943).
28. 92 S.Ct. 596, 599 (emphasis added).
29. 434 F.2d 918, 925.
30. 15 U.S.C. § 78p(b) (1970).
31. *Id.*

deter short-swing insider trading in the sense of insider abuse, or whether the statute is aimed at specific objective transactions — or both. This problem is well illustrated by the frequency of litigation over what constitutes "purchase" and "sale" within the meaning of the Act.[32] In *SEC v. National Securities, Inc.*,[33] the Supreme Court indicated that the commercial and contract definitions of the terms are not definitive for purposes of the 1934 Act. In that case Mr. Justice Marshall said the definition of "purchase" and "sale" under the 1934 Act was "whether respondents' alleged conduct is the type of fraudulent behavior which was meant to be forbidden by the statute and the rule."[34] Over the last thirteen years a similar test has been applied specifically to section 16(b) in several federal court decisions which have considered the subjective possibilities of abuse a pre-requisite to consideration of whether disputed transactions are "purchases" or "sales" within the contemplation of the section.[35] Thus the second circuit has said: "The judicial tendency . . . 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."[36] Consistent with its previous decision, the second circuit in *Stella v. Graham - Paige Motors Corp.*[37] held that the requirement of greater than 10% ownership "at the time" of purchase must be construed to mean "simultaneously with" or by virtue of the purchase, where the purpose of section 16(b) would otherwise be defeated. In the instance where the transaction in issue could not possibly lend itself to the type of abuse envisioned by the section even though, objectively defined, it could be considered a purchase, the eighth circuit in *Petteys v. Butler* refused to find liability.[38]

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32. Cases cited note 35 *infra*. *See also* Comment, *The Scope of "Purchase and Sale" Under Section 16(b) of the Exchange Act*, 59 YALE L.J. 510 (1950); Comment, *Short-Swing "Purchases and Sales" Under the Securities Exchange Act.*, 61 NW. U.L. REV. 448 (1966); Hamilton, *Convertible Securities and Section 16(b): The End of an Era*, 44 TEX. L. REV. 1447 (1966); George, *The Application of Section 16(b) to Mergers: A Hidden Hazard*, 47 TEX. L. REV. 1417 (1969).

33. 393 U.S. 453 (1969).

34. *Id.* at 467.

35. Abrams v. Occidental Petroleum Corp., 450 F.2d 157 (2d Cir. 1971); Newmark v. RKO Gen. Inc., 425 F.2d 348 (2d Cir. 1970), *cert. denied*, 400 U.S. 854 (1970); Bershad v. McDonough, 428 F.2d 693 (7th Cir. 1970), *cert. denied*, 400 U.S. 992 (1971); Blau v. Lamb, 393 F.2d 507 (2d Cir. 1966), *cert. denied*, 385 U.S. 1002 (1967); Blau v. Lehman, 282 F.2d 786 (2d Cir. 1960), *aff'd*, 368 U.S. 403 (1962); 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. 1954), *cert. denied*, 348 U.S. 827 (1954); Shaw v. Dreyfus, 172 F.2d 140 (2d Cir. 1949), *cert. denied*, 337 U.S. 907 (1949).

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

37. 104 F. Supp. 957 (S.D.N.Y. 1955), *modified in other respects*, 232 F.2d 299 (2d Cir. 1956), *cert. denied*, 352 U.S. 831 (1956). That is, by virtue of *Stella*, one who has 0% or 1% and purchases 10½% cannot argue that he was not an owner of more than 10% at the time of purchase if it appears that his transaction is otherwise within the scope of the section.

38. 367 F.2d 528, 538 (8th Cir. 1966), *cert. denied*, 385 U.S. 1006 (1967).

This more flexible treatment is now commonly referred to as the "subjective" or "pragmatic" approach and stands in sharp contrast with an earlier "objective approach" found in such second circuit court of appeals cases as *Smolowe v. Delendo Corp.*[39] and *Park & Tilford, Inc. v. Schulte.*[40] These cases emphasize the mechanical application of the statute in transactions falling within its scope — without consideration of the potential for abuse, the voluntary or involuntary character of the defendant's action, and the legislative purpose underlying the statutory provisions.

Mr. Justice Douglas, writing in the instant case for the three dissenting Justices, argued that such terms as "purchase" and "sale" do not lend themselves to objective definition in their statutory context.[41] In that Congress enacted section 16(b) for the purpose of preventing the abuse of inside information by short-swing speculators, the dissenters felt that once the defendant becomes a statutory "insider", all sales within the six-month period ought to bear a rebuttable presumption of taint.[42] That is, the minority would "construe the statute as allowing a rebuttable presumption that any such series of dispositive transactions will be deemed to be part of a single plan of disposition, and will be treated as a single 'sale' for the purposes of §16(b)."[43] The SEC, as amicus curiae, favored strict liability on all subsequent sales within the six-month period if the owner had more than 10% "at any time during the period in which the sale transactions occur."[44] Arguably, the SEC's position also amounted to a rebuttable presumption, in that the commission's argument stresses that the purpose of the exemptive provision of the section was to exclude from liability certain owners who involuntarily acquired more than ten percent.[45]

Under the "objective" approach of *Smolowe, Park & Tilford* and the majority of the Supreme Court in the instant case, the statute is applied mechanically to transactions which Congress found abusive. Under the "subjective" approach as enunciated in the second, sixth and seventh circuits, by the SEC, and by the dissenters in this case, the section is also applied mechanically, but to the types of transactions which present the opportunity for the kind of abuse Congress sought to prevent. The former approach can well be called transactional, but the latter could be called essentially *personal,*

39. 46 F. Supp. 758 (S.D.N.Y. 1942), *aff'd,* 136 F.2d 231 (2d Cir. 1943), *cert. denied,* 320 U.S. 751 (1943).
40. 160 F.2d 984 (2d Cir. 1947), *cert. denied,* 332 U.S. 761 (1947).
41. 92 S.Ct. 596, 604.
42. *Id.* at 609.
43. *Id.* at 607.
44. Brief for SEC as Amicus Curiae at 14, Reliance Elec. Co. v. Emerson Elec. Co., 92 S.Ct. 596 (1972).
45. *Id.* at 32.

i.e., a court would look to the parties involved in light of the circumstances. In referring to the Supreme Court's decision as a "mutilation of the Act,"[46] Justice Douglas seemed to point to his dissenting opinion in *Blau v. Lehman*,[47] where he summed up his opposition with the same words.[48] In that case, a shareholder in the Tide Water Associated Oil Company brought an action in the corporation's name to recover short-swing profits from Lehman Brothers. One Joseph A. Thomas, a director of the Tidewater Company, had engaged in short-swing trading subject to section 16(b). Thomas was a member of the Lehman Brothers partnership who allegedly had been "deputized" by his partners to sit on the Tidewater board. Lehman Brothers, although not a 10% beneficial owner as specified by section 16(b), did manage to turn a $98,686.77 profit by trading in Tidewater stock during the same period that Thomas made his "insider" profits. The Supreme Court rejected the contention that Lehman Brothers could be considered a "director" under 16(b), unless it could be proven that Thomas was in fact actually deputized by the brokerage house to sit on the Tidewater board. In refusing to find liability for Lehman's profits,[49] Justice Black argued that Congress had considered and rejected a draft provision of the section that would have allowed recovery of any profits made as a result of the unlawful disclosure of inside information from any person.[50]

Justice Douglas' dissent in *Lehman*, as in the *Reliance* case, emphasized that Congress was primarily concerned with combating what the Senate Report termed "predatory operations."[51] The thrust of the language he then went on to quote from that report reflects the same awareness of the reality of insider activity that Douglas seeks to inject into every analysis of section 16(b):

> 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 corporation 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 their companies to enable them to acquire and profit by information not available to others.[52]

46. 92 S.Ct. at 602.
47. 368 U.S. 403, 414 (1962).
48. *Id.* at 415.
49. *Id.* at 414.
50. *Id.* at 412.
51. S. Rep. No. 1455, 73d Cong., 2d Sess. 68 (1934).
52. *Id.* at 55.

Douglas' position in *Lehman* is essentially that any construction of the dimensions of the statute and the congressional intent underlying it should not fall so miserably short of the realities of the marketplace. Significantly, he notes that members of the Lehman firm sat on the boards of some 100 corporations[53] and finds the implications of this fact obvious:

> We forget much history when we give §16 a strict and narrow construction. Brandeis in *Other People's Money* spoke of the office of "director" as a "happy hunting ground" for investment bankers. He said that "The goose that lays golden eggs has been considered a most valuable possession. But even more profitable is the privilege of taking the golden eggs laid by somebody else's goose. The investment bankers and their associates now enjoy that privilege."[54]
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> What we do today allows all but one partner to share in the feast which the one places on the partnership table. They in turn can offer feasts to him in the 99 other companies of which they are directors.[55]

The fact that Douglas emphasized the circumstances and the capabilities of the defendants in *Lehman* and *Reliance*, plus the fact that a line of circuit court decisions from *Abrams* through *National Securities* emphasized the possibility of abuse present in the transaction as a pre-requisite to determination of its relation to the literal terms of section 16(b), indicates that this "subjective" approach is willing to go well beyond the literal language of the section, and look to the parties themselves. While it often cannot be shown that the legislative history of the statute reveals congressional intent vis-a-vis a specific transaction, the *thrust* of the testimony at the hearings undeniably represents congressional concern with the inequity existing between small stockholders and directors, officers and large stockholders, and Congress' intent to deal most stringently with abuse of inside information.

The fact remains that a strict, "objective" and "mechanical" reading of the exemptive provision of section 16(b) supports the Supreme Court's decision in *Reliance*. Notably, the majority opinion omits any reference to the Court's position in *SEC v. National Securities, Inc.*, where Justice Marshall stated that the test of "purchase" or "sale", in terms of the Act, was "whether respondents' alleged conduct is the type of fraudulent behavior which was meant to be forbidden by the statute and the rule."[56] As the ma-

53. 368 U.S. at 414.
54. *Id.* at 419.
55. *Id.* at 420.
56. 393 U.S. 453, 467 (1969).

jority in *Reliance* failed to consider this question, considerable doubt arises concerning the current status of *National Securities.* The fact also remains that the decision in *Reliance* gives approval to a technique by which any 10% beneficial owner may avoid short-swing liability under section 16(b) by merely following the steps allowed by the Court.[57]

After all, the fundamental issue of *Reliance* is the accuracy of the tax analogy supplied by the court of appeals.[58] Accepted tax practice does indeed find tax avoidance a legitimate and proper method of maximizing profits. Yet, the practice of tax avoidance has long been one of the fundamental problems of tax law. Not only must tax avoidance be distinguished from tax evasion, the courts must address themselves to the problems of the government's need to obtain revenue in relation to the taxpayer's interest in economic certainty, and to the dangers of extending the scope of the revenue statutes to arbitrary and burdensome dimensions not intended by Congress.[59] The distinction between substance and form is not at all foreign to tax law.[60]

In this respect, it is especially significant that federal courts have long employed the so-called "Step Transaction Rule." If a transac-

57. Petitioner's Brief for Rehearing at 7, Reliance Elec. Co. v. Emerson Elec. Co., 92 S.Ct. 596 (1972).

58. "[T]here is no reason why a person may not conduct his business in such a way as to intentionally minimize or eliminate his loss of profits under Section 16(b) by any means permitted by law. Such conduct is to some extent analogous to tax avoidance conduct which is permissible." 434 F.2d at 925. The court of appeals in *Reliance* further explained its reasoning, citing to Helvering v. Gregory, 69 F.2d 809 (2d Cir. 1934):

> A transaction, otherwise within the exception of the tax law, does not lose its immunity, because it is actuated by a desire to avoid, or, if one choose, to evade, taxation. Anyone may so arrange the affairs that his taxes shall be as low as possible. *Id.* at 925.

On appeal, the Supreme Court affirmed saying:

The legal right of a taxpayer to decrease the amount of what otherwise would be his taxes, or altogether avoid them, by means which the law permits, cannot be doubted. Gregory v. Helvering, 293 U.S. 465, 469 (1935).

But see Morsman v. Comm'r, 90 F.2d 18, 22 (8th Cir. 1937), *cert. denied,* 302 U.S. 701 (1937):

It is true that a legal transaction will not be denied its intended effect though an underlying motive may have been the evasion of taxes. But the transaction may always be scrutinized to see whether it is in reality what it appears to be. Substance and not form should control in the application of tax laws. When a taxpayer thus boldly proclaims that his intent, at least in part, in attempting to create a trust is to evade taxes, the court should examine the forms used by him for the accomplishment of his purpose with particular care; and, if his ingenuity fails at any point, the court should not lend him its aid by resolving doubts in his favor. (Citations omitted).

59. Rice, *Judicial Techniques in Combating Tax Avoidance,* 51 MICH. L. REV. 1021 (1953).

60. "To permit the true nature of the transaction to be disguised by mere formalisms, which exist solely to alter tax liabilities, would seriously impair the effective administration of the tax policies of Congress." Comm'r v. Court Holding Co., 324 U.S. 331, 334 (1945). *See* Guterman, *Substance v. Form in the Taxation of Personal and Business Transactions,* N.Y.U. 20TH INST. ON FED. TAX 951 (1962).

tion is split into two or more separate parts, for no other apparent reason than to avoid or minimize tax liability, the court will generally impose liability for one transaction if it determines that any other considerations besides tax considerations would render the successive "steps" useless and unnecessary.[61] In essence, this comports with the procedure followed by the district court in *Reliance*, *i.e.*, the objective facts are examined to determine whether the taxpayer acted solely with intent to avoid the statute.

Tax rules, however, do not determine actions under section 16(b).[62] Furthermore, tax law exists for an entirely different purpose than the Securities Exchange Act of 1934. Obviously, policy considerations with respect to the government's revenue-raising activities must differ markedly from its objectives in protecting the small shareholder and the investing public from sharp practice, non-disclosure, and other types of predatory practices. Traditionally, tax statutes are strictly and objectively construed,[63] while a regulatory, "prophylactic" statute merits broad construction:

> We must suppose 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.[64]

Whatever validity there is in the tax analogy must square with the stated purpose of section 16(b). Congress established a presumption in the 10% limitation that 10% ownership means access to inside information, the use of which Congress sought to restrain over a six-month period. If one accepts the presumption, it would be absurd to argue that one forgets such information by selling down to less than 10% and cannot benefit from the information in subsequent sales within the same six-month period.

One immediate effect of the Supreme Court's decision in the *Reliance* case may be to make the cash tender offer more inviting to acquisition-minded corporations. Management has generally taken a dim view of tender offers — they can wrest corporate con-

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61. 324 U.S. at 334. "The incidence of taxation depends upon the substance of a transaction. The tax consequences which arise from gains from a sale of property are not finally to be determined solely by the means employed to transfer legal title. Rather, the transaction must be viewed as a whole, and each step, from the commencement of the negotiations to the consumation of the sale, is relevant." *See also* Helvering v. LeGierse, 312 U.S. 531 (1941); Minnesota Tea Co. v. Helvering, 302 U.S. 609 (1938).

62. *See* 136 F.2d at 238.

63. Masonite Corp. v. Fly, 194 F.2d 257, 260 (5th Cir. 1952): "The intention of the legislature with respect to tax statutes must . . . be ascertained from the language of the act. . . . The literal meaning of the words employed in tax statutes is most important . . . ."

64. 136 F.2d at 239.

trol from stunned officers and directors within a relatively short time. Such displeasure was largely instrumental in the passage of the Williams Bill,[65] which requires companies or persons acquiring more than 10% of the stock in a registered corporation to make certain disclosures as to source of funds, and identity if a take-over bid is contemplated. In view of the probable opposition of the incumbent management and the hostile relationship arising as a result of a cash tender offer, it is arguable that the situation is not one which supports the presumption of access to inside information which Congress wrote into section 16(b). On the other hand, the management of the target corporation certainly has a strong interest in seeing the aggressors sell their stock instead of using it to gain control. If the former can convince the latter that it has the alternative to take advantage of "inside" information which may foretell a rise in the market price of the tendered stock, it may protect its control of the enterprise.

In recent years, *unsuccessful* tender offers and acquisitions related to unsuccessful merger bids have been highly profitable to several corporate "losers".[66] Commonly, one corporation, often one of the fast growing conglomerates, will begin to quietly (or sometimes not so quietly) acquire stock in another corporation. The first corporation may then propose and negotiate a merger. When the fact of the proposed merger, or rumors of it, becomes public, the market price of the stock in one or both of the corporations tends to rise in reflection of investor anticipation of a profitable combined enterprise. If the stock prices do rise, and merger negotiations are not successful, the first corporation may extend a tender offer, acquire more stock, and force the merger, or it may have the opportunity to sell out at a substantial profit before the market prices return to normal levels.[67]

It should be emphasized that in most instances, in the past at least, corporations trading in stock for these purposes take care to stay below the 10% level so as to avoid disclosure, reporting requirements, and possible profit-liability under section 16(b). The instant case, of course, was a notable exception.

One question raised in respect to the Supreme Court's decision in the instant case is whether the Court will limit its effects if presented with an obvious and flagrant example of abuse of inside information by a beneficial owner. Assuming, arguendo, that Emerson had no access to inside information and was in fact completely in-

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65. 82 Stat. 454 (1968), *amending* 15 U.S.C. §§ 78*l*, 78m, 78n (1964).

66. Berton, *Winning Losers; Companies that Have Merger Bids Rejected Profit on Stock Sales,* Wall Street Journal, January 27, 1969 at 1.

67. *Id.*

nocent of any abuse contemplated by section 16(b), the practical effect of this case as between the parties is merely a resolution as to whose stockholders get to keep which portion of the profits. The holding in *Reliance* seems to go so far as to say that even though an insider's knowledge is more than statutory, the "objective standards" of the section clearly contemplate that liability can be limited to profits on holdings exceeding 10%. It remains to be seen what applications this decision may have in the ingenuity of stock traders. Given the Court's repeated insistence on "mechanical" provisions and "objective" application, it is difficult to conceive a basis upon which this decision could be distinguished in the face of an instance of "letter perfect" form and procedure, but where the substance of the transaction literally shines with the type of abuse which led to the enactment of the section.[68]

It also remains to be seen whether Congress will amend the section. Tender offers, merger acquisitions, and corporate reorganizations probably were not contemplated by the framers of the section. With the exception of one amendment in 1964, Congress has been silent on the section. The 1934 Act came largely after the dam-

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68. It is also difficult to overlook the gap which seems to arise between the court's posture in the *Reliance* case and that taken by the SEC as amicus curiae. The aggressive position represented in the SEC's complaint in the controversial *National Student Marketing* case appears manifestly at odds with the conservative, "objective" nature of the high court's decision in *Reliance*. Basically, the complaint in the former case charges two Wall Street law firms with violations of securities law for failure to publicly disclose facts relating to the activities of the client which suggested that the client was likely to violate the law in effectuating a merger plan.

In a recent article, the *Wall Street Journal* noted that the SEC's activities have securities lawyers "shaking in their boots":

> The case is the latest in a series of SEC actions designed to bring lawyers, accountants and bankers within the framework of securities regulations traditionally aimed at stock traders, brokers and publicly held companies.
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> . . . .
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> SEC officials refuse to talk about the National Student Marketing case while it's pending in court. However, the agency has for some time felt that federal securities laws impose on lawyers an obligation beyond simply giving clients legal advice and then letting them do what they want. As the SEC sees it, a lawyer must tell his client whether certain conduct will violate federal securities law; if the client wants to go ahead anyway, the lawyer must withdraw from the case and even tell the SEC that a violation is about to be committed. If he doesn't, according to the SEC's view, then the lawyer is also violating the law.
>
> . . . But perhaps more important, SEC attorneys say, the SEC has also been holding those professions responsibile if they let themselves be used as tools for the execution of a stock fraud.
>
> . . . .
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> What's apparently bothering the SEC is a growing feeling that too many securities lawyers have lost sight of everything but their obligation to be an advocate. As one SEC official put it recently, 'The securities bar is getting to be like the tax bar; it's specializing in finding loopholes in the law.'

Green, *A Bid to Hold Lawyers Accountable to Public Stuns, Angers Firms,* Wall Street Journal, February 15, 1972 at 1.

age was done and it may well be that the horse will be out of the barn again before Congress feels compelled to shut the door. It may also be that congressional silence thus far does not reflect acquiescence to the literal terms of the Act, but rather approval of the "subjective approach" as developed in the second circuit, where the larger part of section 16(b) cases have been tried.[69]

Lastly, it is possible that the Court's decision in the *Reliance* case will deter corporations from bringing actions under section 16(b) (although it should be recognized that many of the 16(b) actions have been commenced through the diligence and impetus of attorneys[70]), in that the recovery will generally be limited to profits on the 10% excess.

William C. Norris — '73

69. The two major stock exchanges are located in the jurisdiction of the southern district of New York. The act or transaction upon which the plaintiff seeks to recover, in a 16(b) action, can be viewed as taking place at the stock exchange for purposes of jurisdiction, regardless of the residence of the plaintiff or defendant. *See* Gratz v. Claughton, 187 F.2d 46 (2d Cir. 1951); Blau v. Mission Corp., 212 F.2d 77 (2d Cir. 1954), *cert. denied*, 347 U.S. 1016 (1954); Grossman v. Young, 70 F. Supp. 970 (S.D.N.Y. 1947).

70. Perhaps this is in no small part a result of Smolowe v. Delendo Corp., 136 F.2d 231 (2d Cir. 1943), which set a precedent that attorney's fees are recoverable in 16(b) actions:

> Since in many cases such as this the possibility of recovering attorney's fees will provide the sole stimulus for the enforcement of § 16(b), the allowance must not be too niggardly. Cf. Murphy v. North American Light & Power Co., D.C.S.D.N.Y., 33 F. Supp. 567.