SECTION 16(b): A SINGLE ANALYSIS OF PURCHASES AND SALES—MERGING THE OBJECTIVE AND PRAGMATIC ANALYSES

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Section 16(b) of the Securities Exchange Act of 1934[1] was designed as a prophylactic measure to curb insiders'[2] abuse of nonpublic information.[3] Courts have interpreted section 16(b) to effectuate its purpose—the prevention of short-term speculation based on inside information.[4] Because motive, that is, the intent to capitalize on inside information, or the actual use of such information is difficult to prove, the section requires disgorgement of all "profits"[5] earned on purchases

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1. 15 U.S.C. § 78p(b) (1976). Section 78p provides in part:

> (a) Every person who is directly or indirectly the beneficial owner of more than 10 per centum of any class of any equity security . . . which is registered pursuant to section 78*l* of this title, or who is a director or an officer of the issuer of such security, shall file . . . a statement indicating his ownership at the close of the calendar month and such changes in his ownership as have occurred during such calendar month.
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> (b) For the purpose of preventing the unfair use of information which may have been obtained by such beneficial owner, director, or officer by reason of his relationship to the issuer, any profit realized by him from any purchase and sale, or any sale and purchase, of any equity security of such issuer . . . within any period of less than six months, . . . shall inure to and be recoverable by the issuer, 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.

2. Officers, directors, and holders of 10% of the outstanding shares of a class of the issuer's securities are insiders. 15 U.S.C. § 78p(a) (1976). For a discussion of the scope of the definition of an officer, see Comment, *Section 16(b) of the Securities and Exchange Act of 1934: Is a Vice President an Officer?*, 58 NEB. L. REV. 733 (1979).

3. Foremost-McKesson, Inc. v. Provident Sec. Co., 423 U.S. 232, 234 (1976); Kern County Land Co. v. Occidental Petroleum Corp., 411 U.S. 582, 592-93 n.23 (1973); Reliance Elec. Co. v. Emerson Elec. Co., 404 U.S. 418, 422 (1972); S. & S. Realty Corp. v. Kleer-Vu Indus. Inc., 575 F.2d 1040, 1044 (2d Cir. 1978); American Standard, Inc. v. Crane, 510 F.2d 1043, 1054 (2d Cir. 1974), *cert. denied*, 421 U.S. 1000 (1975); Lewis v. Varnes, 505 F.2d 785, 787-88 (2d Cir. 1974).

Application of the statute is limited to trading equity securities of an issuer with a class of securities registered with the Securities and Exchange Commission under the Securities Exchange Act of 1934. 15 U.S.C. § 78p(a) (1976).

4. *See, e.g.*, Adler v. Klawans, 267 F.2d 840, 844 (2d Cir. 1959).

5. "Profits" are normally calculated to maximize the amount recouped from the insider. Thus, the highest-sale price is matched with the lowest-purchase price in a given six-month period. Gratz v. Claughton, 187 F.2d 46, 51-52 (2d Cir.), *cert. denied*, 341 U.S. 920 (1951); Makofsky v. Ultra Dynamics Corp., 383 F. Supp. 631, 639 (S.D.N.Y. 1974). Rather than using strict matching,

and sales occurring within a six-month period[6] regardless of motive or actual use of inside information.[7] Thus, courts have favored a literal application of the statute so that insiders can know with some degree of certainty the conduct prohibited by section 16(b).[8]

Nevertheless, judicial disagreement exists concerning the section's applicability to certain transactions.[9] Courts have not been able to for-

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some courts have used average prices. *See* Allis-Chalmers Mfg. Co. v. Gulf & W. Indus., Inc., 527 F.2d 335, 356-57 (7th Cir. 1975), *cert. denied*, 423 U.S. 1078, *cert. denied*, 424 U.S. 928 (1976).

Purchases and sales of related securities may be matched if they are sufficiently related to permit in-and-out trading between the two classes: for example, between common and convertible preferred. *See* 2 L. Loss, SECURITIES REGULATION 1059 (2d ed. 1961); Hamilton, *Convertible Securities and Section 16(b): The End of an Era*, 44 TEX. L. REV. 1447, 1489 (1966); Rubin & Feldman, *Statutory Inhibitions upon Unfair Use of Corporate Information by Insiders*, 95 U. PA. L. REV. 468, 486 (1947). However, unrelated classes of securities will not be matched. *See* Smolowe v. Delendo Corp., 136 F.2d 231, 237 n.13 (2d Cir.), *cert. denied*, 320 U.S. 751 (1943); Hamilton, *supra*, at 1489.

6. Section 16(b) specifies a period of "less than six months." This period begins on the date of the initial transaction. It extends to the second day prior to the date in the sixth month that corresponds numerically to the date of the initial transaction. Stella v. Graham-Paige Motors Corp., 132 F. Supp. 100, 103-04 (S.D.N.Y. 1955), *remanded on other grounds*, 232 F.2d 299 (2d Cir.), *cert. denied*, 352 U.S. 831 (1956).

7. *See, e.g.*, Reliance Elec. Co. v. Emerson Elec. Co., 404 U.S. 418, 422 (1972); Heli-Coil Corp. v. Webster, 352 F.2d 156, 165 (3d Cir. 1965). Conversely, insiders may trade on the basis of inside information with impunity from section 16(b) liability if they do not purchase and sell within the six-month period. *See* Roberts v. Eaton, 212 F.2d 82, 85 (2d Cir.), *cert. denied*, 348 U.S. 827 (1954).

Section 16(b) does not reach all trading on the basis of inside information, 404 U.S. at 422; Blau v. Lehman, 368 U.S. 403, 411-12 (1962); Adler v. Klawans, 267 F.2d 840, 845 (2d Cir. 1959), and courts may not expand application of section 16(b) beyond its admittedly narrow bounds—expansion is the prerogative of Congress. 368 U.S. at 412-13. Courts have found it within their power, however, to narrow the scope of section 16(b) when literal application of the statute is not required to further its purpose. Foremost-McKesson, Inc. v. Provident Sec. Co., 423 U.S. 232, 244, 251-52, 255 (1976); Kern County Land Co. v. Occidental Petroleum Corp., 411 U.S. 582, 594-95 (1973); Petteys v. Butler, 367 F.2d 528, 536 (8th Cir. 1966), *cert. denied*, 385 U.S. 1006 (1967). *See generally* Blau v. Lamb, 363 F.2d 507, 516 (2d Cir. 1966), *cert. denied*, 385 U.S. 1002 (1967).

Courts have been eager to give broad effect to section 16(b) to prevent fraud by insiders; however, with the vast expansion of proscribed behavior under rule 10b-5, 17 C.F.R. § 240.10b-5 (1981), no purpose is served by an expansive interpretation of section 16(b). *See* Hazen, *The New Pragmatism Under Section 16(b) of the Securities Exchange Act of 1934*, 54 N.C.L. REV. 1, 2-4 (1975); Lowenfels, *Section 16(b): A Trend in Regulating Insider Trading*, 54 CORNELL L. REV. 45, 61-64 (1968); Note, Reliance Electric *and 16(b) Litigation: A Return to the Objective Approach?*, 58 VA. L. REV. 907, 914-15 (1972).

8. *See, e.g.*, Lewis v. Varnes, 505 F.2d 785, 789 (2d Cir. 1974).

9. *See* Kern County Land Co. v. Occidental Petroleum Corp., 411 U.S. 582, 593 (1973); Morales v. Mapco, Inc., 541 F.2d 233, 235 (10th Cir. 1976), *cert. denied*, 429 U.S. 1053 (1977). *Compare* Matas v. Siess, 467 F. Supp. 217 (S.D.N.Y. 1979) (insider's exercise of stock appreciation rights under an option plan is both a purchase and a sale) *with* Rosen v. Drisler, 421 F. Supp. 1282 (S.D.N.Y. 1976) (repurchase of insider's options by issuer is neither a purchase nor a sale) *and compare* Booth v. Varian Assocs., 334 F.2d 1 (1st Cir. 1964), *cert. denied*, 379 U.S. 961 (1965) (no purchase until insider knows amount and price of stock) *with* Prager v. Sylvestri, 449 F. Supp. 425 (S.D.N.Y. 1978) (purchase occurs when insider becomes irrevocably committed to transaction).

mulate a single set of criteria for characterizing purchases and sales applicable to all transactions.[10] Currently, the determination whether a transaction is a purchase or sale may depend not only on its characteristics, but also on the purchaser's actual knowledge[11] or a court's decision that a transaction is ordinary or unorthodox.[12] The usual explanation for the dissimilar treatment of transactions is that courts must apply the statute mechanically or "objectively" to ordinary transactions to effectuate its purpose, but must apply the statute flexibly or "pragmatically" to unorthodox transactions to accomplish the same goal.[13] This dichotomy has made it difficult for insiders to determine what transactions will be considered purchases or sales, and numerous insiders have been held liable for transactions that they could not have known were covered by the statute.[14] This uncertainty should not exist in section 16(b) analysis. The analysis used to characterize transactions as purchases or sales should be the same for all transactions.[15] Indeed, scrutiny of the objective and pragmatic approaches reveals that they

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A number of commentators have analyzed particular types of transactions to determine whether and when purchases or sales take place for section 16(b) purposes. *See, e.g.*, Husband & Powers, *Section 16(b) of the Securities Exchange Act of 1934 and Insider Trading Involving Issuer-Granted Employee Stock Options*, 57 DEN. L.J. 71, 94-95 (1979); Tomlinson, *The Application of Section 16(b) to Qualified Employee Benefit Plans*, 33 STAN. L. REV. 231 (1981); Note, *Put and Call Options Under Section 16 of the Securities Exchange Act*, 69 YALE L.J. 868, 876-77 (1960).

10. *See* Portnoy v. Seligman & Latz, Inc., 516 F. Supp. 1188, 1192 (S.D.N.Y. 1981); Hazen, *supra* note 7, at 3. The terms "purchase" and "sell" are defined broadly in the 1934 Act: "The terms 'buy' and 'purchase' each include any contract to buy, purchase, or otherwise acquire. The terms 'sale' and 'sell' each include any contract to sell or otherwise dispose of." 15 U.S.C. §§ 78c(a)(13)-(14) (1976). For purposes of section 16(b), purchases and sales are not defined solely in terms of normal commercial principles. Bershad v. McDonough, 428 F.2d 693, 697 (7th Cir. 1970), *cert. denied*, 400 U.S. 992 (1971); Lewis v. Dwyer, 365 F. Supp. 607, 608-09 (D. Mass. 1973). The terms purchase and sale are used to indicate the inception and termination of an investment. *See* Heli-Coil Corp. v. Webster, 352 F.2d 156, 172 (3d Cir. 1965) (Hastie, J., dissenting in part and concurring in part); Morales v. Gould Investors Trust, 445 F. Supp. 1144, 1150 (S.D.N.Y. 1977).

11. Gold v. Sloan, 486 F.2d 340, 344 (4th Cir. 1973), *cert. denied*, 419 U.S. 873 (1974).

12. Allis-Chalmers Mfg. Co. v. Gulf & W. Indus., Inc., 527 F.2d 335, 351 (7th Cir. 1975), *cert. denied*, 423 U.S. 1078, *cert. denied*, 425 U.S. 928 (1976); Mouldings, Inc. v. Potter, 465 F.2d 1101, 1104 (5th Cir. 1972), *cert. denied*, 410 U.S. 929 (1973); Morales v. Gould Investors Trust, 445 F. Supp. 1144, 1148 (S.D.N.Y. 1977); Lewis v. Arcara, 401 F. Supp. 449, 452 (S.D.N.Y. 1975).

13. *See* Lewis v. Varnes, 505 F.2d 785, 789 (2d Cir. 1974) (courts are free to adopt the pragmatic approach to section 16(b) only if section 16(b) is intrinsically ambiguous or if alternate plausible applications are available in a particular factual situation).

14. *See, e.g.*, Gold v. Sloan, 486 F.2d 340, 343 (4th Cir. 1973), *cert. denied*, 419 U.S. 873 (1974) (each unorthodox transaction must be examined individually to determine the applicability of the statute); Matas v. Siess, 467 F. Supp. 217, 220-21 (S.D.N.Y. 1979); Hazen *supra* note 7, at 2; McElroy, *Pragmatic Disgorging of Insider Profits: A Review of Cases Reported Under Section 16(b)*, 7 ST. MARY'S L.J. 473, 480 (1975); Note, *supra* note 7, at 911-12.

15. The Supreme Court has already questioned the distinction between the objective and the subjective analysis, Kern County Land Co. v. Occidental Petroleum Corp., 411 U.S. 582, 594 n.25 (1973), but thus far the lower courts have continued to apply this distinction. See notes 38-40 *infra* and accompanying text.

share a common set of principles which can be used to determine whether a transaction is a purchase or sale. Proper application of these principles eliminates the threshold question of whether a transaction is unorthodox.

This article constructs a single analytical model from the objective and the pragmatic approaches to section 16(b). The discussion begins with an overview of both approaches, followed by a demonstration that both the objective and the pragmatic analyses are based for the most part on principles that form a single set of criteria applicable to any transaction.

I. THE OBJECTIVE AND PRAGMATIC ANALYSES

A. *The Objective Analysis*

The earliest judicial interpretations of section 16(b) adopted an objective analysis.[16] Under the objective analysis any transfer of beneficial ownership for value is a purchase and sale.[17] The analysis permits no inquiry into an insider's motive or his access to, or use of, inside information.[18] Access to inside information is conclusively presumed because of the insider's relationship to the issuer.[19] This approach requires only a factual inquiry: has a transfer for value occurred?[20] This simple approach does not, however, resolve the difficult issue of determining when the purchase or sale takes place. Courts have developed two methods to determine when the purchase or sale occurs.

16. *See, e.g.*, Smolowe v. Delendo Corp., 136 F.2d 231 (2d Cir.), *cert. denied*, 320 U.S. 751 (1943).

17. *See* Kern County Land Co. v. Occidental Petroleum Corp., 411 U.S. 582, 594 (1973); Allis-Chalmers Mfg. Co. v. Gulf & W. Indus., Inc., 527 F.2d 335, 351 (7th Cir. 1975), *cert. denied*, 423 U.S. 1078, *cert. denied*, 424 U.S. 928 (1976); Lewis v. Varnes, 505 F.2d 785, 789 (2d Cir. 1974); Blau v. Oppenheim, 250 F. Supp. 881, 884-85 nn.13-19 (S.D.N.Y. 1966). For a critique of the objective approach, see Note, *supra* note 7.

The transfer must be for value, because gifts, transfers by will, and similar transactions are not purchases or sales. Shaw v. Dreyfus, 172 F.2d 140, 142 (2d Cir.), *cert. denied*, 337 U.S. 907 (1949); *see* Rubin & Feldman, *supra* note 5, at 485. Also, transactions where no consideration is paid, *e.g.*, stock splits and pro rata warrant distributions, are not insider purchases. 172 F.2d at 142; Truncale v. Blumberg, 80 F. Supp. 387, 390-91 (S.D.N.Y. 1948).

18. Heli-Coil Corp. v. Webster, 352 F.2d 156, 165 (3d Cir. 1965); Smolowe v. Delendo Corp., 136 F.2d 231, 235-36 (2d Cir.), *cert. denied*, 320 U.S. 751 (1943); Arkansas La. Gas Co. v. W.R. Stephens Inv. Co., 141 F. Supp. 841, 845 (W.D. Ark. 1956).

19. Whittaker v. Whittaker Corp., 639 F.2d 516, 521-22 (9th Cir.), *cert. denied*, 50 U.S.L.W. 3375 (U.S. Nov. 9, 1981) (No. 80-1403); American Standard, Inc. v. Crane Co., 510 F.2d 1043, 1053 (2d Cir. 1974), *cert. denied*, 421 U.S. 1000 (1975); Booth v. Varian Assocs., 334 F.2d 1, 3 (1st Cir. 1964); Smolowe v. Delendo Corp., 136 F.2d 231, 235-36 (2d Cir.), *cert. denied*, 320 U.S. 751 (1943); Fistel v. Christman, 133 F. Supp. 300, 303 (S.D.N.Y. 1955). *See* Stella v. Graham-Paige Motors Corp., 232 F.2d 299, 301 (2d Cir.), *cert. denied*, 352 U.S. 831 (1956).

20. Blau v. Lamb, 363 F.2d 507, 515 (2d Cir. 1966), *cert. denied*, 385 U.S. 1002 (1967). *See* Lowenfels, *supra* note 7, at 47.

1. *Irrevocable commitment*. In the mid-1950s, the Court of Appeals for the Second Circuit held that a purchase occurs when the purchaser is irrevocably committed to take and pay for the stock.[21] The court reasoned that the transfer of beneficial ownership, not the actual transfer of title, is the decisive consideration.[22] The court recognized that the purpose of section 16(b) is to prevent insider speculation by requiring disgorgement of profits.[23] Because an insider can profit from speculation as soon as he is assured of a fixed quantity of stock at a fixed price, the court reasoned that a purchase occurs at the moment the insider is obligated to purchase the stock.[24] Once an insider is obligated to take and pay for the stock, he acquires the ability to profit, even if title is not transferred until a later time and the consideration is not yet paid or even calculated.[25] Under similar reasoning, a sale

21. Blau v. Ogsbury, 210 F.2d 426, 427 (2d Cir. 1954). *Blau* is the leading case for determining the date of purchase of a security. Ogsbury held a stock option which provided that once he notified the corporation of his election to purchase the stock, he would be irrevocably bound to purchase the stock, although title and stockholder rights would not be transferred until payment. Ogsbury delivered an election to purchase in December 1945, but postponed payment until December 1948. In July 1948, within six months of payment for the stock, Ogsbury sold some shares of the stock. Blau contended that the December 1948 payment of the purchase price constituted the date of purchase. The court held that "the 'purchase' was consummated in 1945 when Ogsbury mailed his notice of election and thereby incurred an irrevocable liability to take and pay for the stock." *Id.* Many courts have followed the *Blau v. Ogsbury* irrevocable-commitment analysis. *See, e.g.*, Portnoy v. Revlon, Inc., 650 F.2d 895, 898 (7th Cir. 1981); Lewis v. Musham, [Current] FED. SEC. L. REP. (CCH) ¶ 97,802 (S.D.N.Y. 1980); Morales v. Reading & Bates Offshore Drilling Co., 392 F. Supp. 41, 44-45 (N.D. Okla. 1975); Lewis v. Dwyer, 365 F. Supp. 607, 609 (D. Mass. 1973).

The contract to acquire and sell the stock must be irrevocable by both parties to the transaction. Hence, the Court of Appeals for the Second Circuit has held that the execution of a purchase contract contingent on the buyer's obtaining suitable financing is not a purchase because the buyer does not incur an irrevocable liability to take and pay for the stock. Stella v. Graham-Paige Motors Corp., 232 F.2d 299, 301 (2d Cir.), *cert. denied*, 352 U.S. 831 (1956). Similarly, a buyer not having satisfied all of the conditions precedent to a purchase contract was held not to have made a purchase until the closing under the contract. Morales v. Gulf Energy & Dev. Corp. [1977-1978 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,222 (D. Colo. 1977); Lewis v. Realty Equities Corp., 396 F. Supp. 1026, 1029 (S.D.N.Y. 1975). Certainty about all terms of a contract is not, however, required to find a purchase; the contract must only irrevocably bind the parties to transfer the securities. Oliff v. Exchange Int'l Corp., 449 F. Supp. 1277, 1297 (N.D. Ill. 1978).

22. Blau v. Ogsbury, 210 F.2d 426, 427 (2d Cir. 1954); *see* Whiting v. Dow Chem. Co., 523 F.2d 680, 685-86 (2d Cir. 1975); Champion Home Builders Co. v. Jeffress, 490 F.2d 611, 616 (6th Cir.), *cert. denied*, 416 U.S. 986 (1974).

23. Blau v. Ogsbury, 210 F.2d at 427.

24. *Id.*; *see* Whittaker v. Whittaker Corp., 639 F.2d 516, 525-26 (9th Cir.), *cert. denied*, 50 U.S.L.W. 3375 (U.S. Nov. 9, 1981) (No. 80-1903).

25. *See* Prager v. Sylvestri, 449 F. Supp. 425, 432-33 (S.D.N.Y. 1978); Landy v. United Fruit Co., 305 F. Supp. 254, 257 (D.N.J. 1969). *But see* Booth v. Varian Assocs., 334 F.2d 1 (1st Cir. 1964), *cert. denied*, 379 U.S. 961 (1965). Expanding on Blau v. Ogsbury, the Court of Appeals for the First Circuit held in *Booth* that notwithstanding the irrevocable nature of a purchase contract, the risks attendant to ownership must pass to the purchaser or execution of the contract will not constitute a purchase. 334 F.2d at 4. In *Booth* a firm contract was executed requiring the ex-

would occur when the seller is irrevocably committed to deliver the stock to a purchaser.

2. *Economic realities*. Because the irrevocable commitment analysis is inadequate in some situations,[26] a variant of that doctrine has emerged. Under this modified analysis a purchase occurs when an insider agrees to a substantial economic forfeiture if he does not take and pay for the stock.[27]

The rationale underlying this analysis is similar to that supporting the irrevocable commitment analysis. Barring a significant decline in the value of the securities, the insider is, in an economic sense, obligated to take and pay for the stock. A typical example of this obligation is the purchase of an option where the option price is large and is deducted from a fixed purchase price for the stock. In reality the option price is a downpayment on the stock, and unless the purchaser takes the stock, he suffers a large forfeit. The option is analogous to a credit-purchase contract secured by a pledge of stock. In option contract situations courts have held that the purchase occurs when the option contract is executed, because that is when a change in beneficial ownership takes place.[28] Because the economic-realities approach fo-

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change of the buyer's shares for shares of Varian Associates. The contract specified that the exchange would take place three and one-half years after its execution and would be based on the market price of Varian shares on the date before the closing. Hence, the purchasers did not have an economic risk of gain or loss on the Varian stock until the day before the closing. The court reasoned that the purchase did not occur until the buyer had assumed the risk. In *Booth* the risk was assumed on the day the purchase price was fixed. *Id.* at 5.

The district court for the Southern District of New York recently rejected the *Booth* analysis. *See* Prager v. Sylvestri, 449 F. Supp. 425, 434 (S.D.N.Y. 1978). The district court noted that once a transaction is irrevocable, there is no possibility of speculative abuse. Thus, although the risk of gain or loss on the stock does not pass, if the buyer is irrevocably obligated to take the shares, a purchase occurs at the time of execution of the contract. The court stated:

> the critical moment in the initial "purchase" or "sale," for the purpose of determining when that transaction occurred within the meaning of § 16(b), is that point at which the investor becomes irrevocably committed to the transaction and, in addition, no longer has control over the transaction in any way that could be turned to speculative advantage by the investor.

Id. at 432-33.

26. *See, e.g.*, Bershad v. McDonough, 428 F.2d 693 (7th Cir. 1970), *cert. denied*, 400 U.S. 992 (1971); Ferraiolo v. Newman, 259 F.2d 342 (6th Cir. 1958), *cert. denied*, 359 U.S. 927 (1959).

27. *See* Ferraiolo v. Newman, 259 F.2d 342, 346 (6th Cir. 1958), *cert. denied*, 359 U.S. 927 (1959). Similarly, a sale occurs when the insider would suffer a significant economic forfeiture if he does not deliver the stock to the purchaser.

28. Bershad v. McDonough, 428 F.2d 693, 698 (7th Cir. 1970), *cert. denied*, 400 U.S. 992 (1971) (forfeiture of a "binder" of 14% of the purchase price). *But see* Kern County Land Co. v. Occidental Petroleum Corp., 411 U.S. 582, 603-04 (1973) (forfeiture of an option premium of nine percent of the purchase price was not sufficient to cause the option to be a sale). Bolstering the argument in *Bershad* were the facts that the stock was delivered to an escrow agent pending completion of the transaction and a proxy to vote the stock was delivered to the purchaser.

cuses on when the purchase or sell decision becomes effectively irreversible, it can be seen as a variant of the irrevocable commitment analysis.

B. *The Pragmatic Analysis*

The objective approach to section 16(b), with its two modes of analysis, is serviceable, but it can lead to harsh results.[29] For example, some courts have held that conversions of preferred stock to common stock and exchanges of securities through a merger are purchases of the newly received securities.[30] Some of these "purchases" forced insiders to disgorge profits that either resulted from long-term investments or were earned in an involuntary transaction in which inside information could not have been used.[31]

In response to these problems, the Court of Appeals for the Sixth Circuit developed the pragmatic approach to section 16(b) in the late 1950s.[32] The pragmatic approach involves a number of elements.[33] First, and most important, it applies only in certain unusual circumstances.[34] If these circumstances exist, then the transaction is characterized as "unorthodox." Unorthodox transactions are ill-defined, but they usually have peculiar features that either make it unfair to apply section 16(b) or make it difficult to determine whether or when a purchase or sale has taken place.[35] Generally, transactions not involv-

29. *See* Mouldings, Inc. v. Potter, 465 F.2d 1101, 1104 (5th Cir. 1972), *cert. denied*, 410 U.S. 929 (1973); Petteys v. Butler, 367 F.2d 528, 535-36 (8th Cir. 1966), *cert. denied*, 385 U.S. 1006 (1967).

30. Heli-Coil v. Webster, 352 F.2d 156 (3d Cir. 1965); Blau v. Mission Corp., 212 F.2d 77 (2d Cir.), *cert. denied*, 347 U.S. 1016 (1954); Park & Tilford v. Schulte, 160 F.2d 984 (2d Cir.), *cert. denied*, 332 U.S. 761 (1947); Blau v. Hodgkinson, 100 F. Supp. 361 (S.D.N.Y. 1951).

31. *See, e.g.*, Park & Tilford v. Schulte, 160 F.2d 984, 988 (2d Cir.), *cert. denied*, 332 U.S. 761 (1947) (requiring the return of profit arising from the conversion of preferred stock to common in addition to the profit arising out of the "short-swing" appreciation of the common stock so acquired).

32. Ferraiolo v. Newman, 259 F.2d 342 (6th Cir. 1958), *cert. denied*, 359 U.S. 927 (1959).

33. The Court of Appeals for the Second Circuit later followed the Court of Appeals for the Sixth Circuit in Blau v. Lamb, 363 F.2d 507 (2d Cir. 1966), and eventually the Supreme Court adopted the pragmatic approach for "unorthodox" transactions. *See* Kern County Land Co. v. Occidental Petroleum Corp., 411 U.S. 582 (1973). For a discussion of the evolution of the pragmatic approach, see Hazen, *supra* note 7, at 20-26; Lowenfels, *supra* note 7, at 50-57; Note, *Insider Liability for Short-Swing Profits: The Substance and Function of the Pragmatic Approach*, 72 MICH. L. REV. 592 (1974). For a general critique of the approach, see Note, *Exceptions to Liability Under Section 16(b): A Systematic Approach*, 87 YALE L.J. 1430 (1978).

34. *See, e.g.*, Whittaker v. Whittaker Corp., 639 F.2d 516, 522 (9th Cir.), *cert. denied*, 50 U.S.L.W. 3375 (U.S. Nov. 9, 1981) (No. 80-1903); Lewis v. Musham, [Current] FED. SEC. L. REP. (CCH) ¶ 97,802 (S.D.N.Y. 1980); Matas v. Siess, 467 F. Supp. 217, 220-21 (S.D.N.Y. 1979).

35. *See generally* Kern County Land Co. v. Occidental Petroleum Corp., 411 U.S. 582, 593-600 (1973).

ing the payment of cash, for example an exchange of securities, are considered unorthodox.[36]

If a transaction is unorthodox, courts employ the pragmatic approach to section 16(b).[37] Under the pragmatic approach, as under the objective approach, section 16(b) applies only if the transaction involves a transfer of beneficial ownership for value.[38] But, unlike the objective approach, under the pragmatic approach such a transfer is not a purchase or sale if there is no possibility of speculative abuse in the transaction.[39] The possibility of speculative abuse exists if the insider has access to inside information, whether or not he actually uses that information, and he has control over both the decision to buy or sell and the timing of the purchase or sale.[40]

The rationale underlying the pragmatic approach is simple. Section 16(b) should be applied only when the purpose of the statute—the prevention of the use of inside information in purchases or sales of securities[41]—can be furthered. An insider without access to inside information obviously cannot use it. Further, even if the insider possesses the information, it cannot be used when the purchase or sale is involun-

36. *See id.* at 593-99 & nn.24 & 26. The Supreme Court listed transactions involving warrants, options, mergers, and corporate reorganizations as unorthodox. *Id.*

37. *See, e.g.*, Whittaker v. Whittaker Corp., 639 F.2d 516, 522 (9th Cir.), *cert. denied*, 50 U.S.L.W. 3375 (U.S. Nov. 9, 1981) (No. 80-1903); Rosen v. Drisler, 421 F. Supp. 1282, 1286 (S.D.N.Y. 1976). In addition, at least two courts have eschewed the objective approach even as applied to orthodox transactions. Oliff v. Exchange Int'l Corp., 449 F. Supp. 1277, 1290 (N.D. Ill. 1978); Makofsky v. Ultra Dynamics Corp., 383 F. Supp. 631, 637-38 (S.D.N.Y. 1974). One court has applied both analyses. Morales v. Mapco, Inc., 541 F.2d 233, 235-36 (10th Cir. 1976), *cert. denied*, 429 U.S. 1053 (1977).

38. Lewis v. Riklis, 446 F. Supp. 582, 586 (S.D.N.Y.) (no cases exist predicating liability on an unconsummated transaction), *aff'd*, 575 F.2d 416 (2d Cir. 1978).

39. *See* Kern County Land Co. v. Occidental Petroleum Corp., 411 U.S. 582, 595, 600-01 (1973).

40. *Id.* at 600; Morales v. Gould Investors Trust, 445 F. Supp. 1144, 1150 (S.D.N.Y. 1977), *aff'd*, 578 F.2d 1369 (2d Cir. 1978); Makofsky v. Ultra Dynamics Corp., 383 F. Supp. 631, 639-40 (S.D.N.Y. 1974); Alloys Unlimited, Inc. v. Gilbert, 319 F. Supp. 617, 619 (S.D.N.Y. 1970). *But cf.* Tyco Laboratories, Inc. v. Cutler-Hammer, Inc., 490 F. Supp. 1, 5-8 (S.D.N.Y. 1980) (control over the timing of a sale and the possibility of speculative abuse are independent criteria for determining the applicability of section 16(b); satisfaction of either criterion is sufficient to cause liability to attach). The insider need not be aware of the possibility of speculative abuse. Makofsky v. Ultra Dynamics Corp., 383 F. Supp. 631, 638 (S.D.N.Y. 1974).

The limits of the "possibility of abuse" element of the pragmatic approach to section 16 are discussed in Note, *Insider Liability for Short-Swing Profits: The Substance and Function of the Pragmatic Approach*, 72 MICH. L. REV. 592 (1974). Briefly, the insider must have had an opportunity for speculative abuse, whether or not the insider knew of this opportunity or acted because of it, *id.* 597 n.26, and the opportunity probably need have been present only at the time of the transaction under scrutiny, not at both the time of purchase and of sale, *id.* 598-601.

41. See note 4 *supra* and accompanying text.

tary.[42] No purpose is served by imposing section 16(b) liability in either of these instances.

II. The Common Underpinnings of the Two Analyses

Presently, courts characterize a transaction as orthodox or unorthodox and then apply either the objective or pragmatic standard. The orthodox/unorthodox distinction is neither necessary nor conducive to a proper analysis of section 16(b). The theoretical underpinnings of both the objective and pragmatic approaches are the same. The following table summarizes the important elements of each approach.

Objective Approach	Pragmatic Approach
1. Requires transfer of beneficial ownership for value.	1. Requires unorthodox transfer of beneficial ownership.
2. Presumes access to inside information.	2. Requires possibility of speculative abuse, which involves two subelements:
3. Purchase or sale occurs when change in beneficial ownership takes place.	(a) access to inside information, and
	(b) control over the timing of the transaction.

As the table shows, the elements of the two approaches are virtually identical. Each approach is based on three common elements: a transfer of beneficial ownership for value, access to inside information, and an investment decision.

A. *Transfer of Beneficial Ownership for Value*

Leaving aside the orthodox or unorthodox nature of the transaction, both approaches require a transfer of beneficial ownership for value, the most difficult element in either analysis and the one courts find most confusing. The pragmatic approach arose from cases in which the insider had exchanged one class of security for another.[43] Courts were dissatisfied with the harsh results that occurred when these exchanges were held to be purchases and sales. In response, some

42. *See* Heli-Coil Corp. v. Webster, 352 F.2d 156, 167-68 (3d Cir. 1965) (no section 16(b) profit until there is a definitive act by the insider); Computer Power Int'l Corp. v. Alpern, [1979 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 96,901 (S.D.N.Y. June 19, 1979); Lynam v. Livingston, 276 F. Supp. 104, 107 (D. Del. 1967).

43. *See, e.g.*, 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); Rothenberg v. United Brands Co., [1977-1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 96,045 (S.D.N.Y. May 11, 1977), *aff'd*, 573 F.2d 1295 (2d Cir. 1977).

courts devised an elaborate analysis requiring inquiry into the possibility of speculative abuse in the transaction.[44] This inquiry allowed courts to conclude that most of these exchanges were not subject to section 16(b) because they were not purchases or sales.[45] Each court that looked at a transaction in which preferred stock was converted to common stock found correctly that the preferred was the economic equivalent of the common; therefore, the insider had had beneficial ownership of the common for as long as he had held the preferred.[46] The Court of Appeals for the Ninth Circuit, for example, without analyzing the possibility of speculative abuse, concluded that characterizing such a conversion as a purchase was illogical.[47] It was unnecessary to examine the possibility of use of inside information because the presence or absence of a transfer for value was the dispositive factor. These cases could therefore have been resolved under the objective analysis as well as under the pragmatic analysis.[48]

B. *Access to Inside Information*

Section 16(b) literally applies to all insiders regardless of their involvement with the issuer;[49] therefore, under the objective approach, insiders are presumed to have access to inside information and proof to the contrary is not permitted.[50] The pragmatic approach varies this formulation: an insider can avoid liability by proving lack of access to inside information, but not by proving failure to use it.[51]

This distinction does not withstand scrutiny. The rationale of the pragmatic approach is that, because section 16(b) is intended to prevent the use of inside information, the section should not apply to those who, because of lack of access, could not have used inside information.[52] This rationale would also support an exemption for insiders who do not actually use inside information, or who are not aware of

44. *See* Blau v. Lamb, 363 F.2d 507, 516 (2d Cir. 1966), *cert. denied*, 385 U.S. 1002 (1967); Ferraiolo v. Newman, 259 F.2d 342, 345 (6th Cir. 1958), *cert. denied*, 359 U.S. 927 (1959).

45. *E.g.*, Blau v. Lamb, 363 F.2d 507, 519-23 (2d Cir. 1966), *cert. denied*, 385 U.S. 1002 (1967); Ferraiolo v. Newman, 259 F.2d 342, 346 (6th Cir. 1958), *cert. denied*, 359 U.S. 927 (1959).

46. *E.g.*, Blau v. Lamb, 363 F.2d 507, 521-23 (2d Cir. 1966), *cert. denied*, 385 U.S. 1002 (1967); Ferraiolo v. Newman, 259 F.2d 342, 346 (6th Cir. 1958), *cert. denied*, 359 U.S. 927 (1959).

47. Blau v. Max Factor & Co., 342 F.2d 304 (9th Cir.), *cert. denied*, 382 U.S. 892 (1965).

48. *See* Hayes v. Sampson, [1980 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 97,693 (S.D.N.Y. Nov. 19, 1980); *cf.* Chemical Fund, Inc. v. Xerox Corp., 377 F.2d 107 (2d Cir. 1967) (convertible debentures were held equivalent to stock without resort to pragmatic analysis).

49. See note 20 *supra* and accompanying text.

50. See notes 18-19 *supra* and accompanying text.

51. See notes 39-42 *supra* and accompanying text.

52. See notes 41-42 *supra* and accompanying text.

their access to it.[53] Proving either circumstance is difficult, and allowing exemptions based on such proof would greatly dilute the certainty of the statute—a certainty the statute's language seems to require.[54] A better approach is to apply the statute to all insiders whether or not they have access to inside information. An alternative, less Draconian approach would be to apply the statute only to those actually using inside information.

In any event, the ability to escape liability by proving lack of access to inside information is not of practical significance. The only insiders likely to carry the burden of proving lack of access are participants in unfriendly, partially successful take-over attempts or other ten-percent shareholders at odds with an entrenched management.[55] These insiders do not have to prove lack of access to avoid liability because they can avoid purchasing and selling within six months unless one of the transactions is involuntary. If the transaction is involuntary, no possibility of speculative abuse exists.[56] In short, the two section 16(b) approaches treat access to inside information under unnecessarily different standards.[57] The proper standard assumes access to inside information.

C. *Investment Decision*

The remaining elements of the two analyses—the time of the purchase or sale of beneficial ownership and control over the timing of the transaction—both address the same critical issue: did the insider make an investment decision? Even if a transfer of beneficial ownership for value has occurred, both analyses require that the transfer result from the insider's investment decision before the transaction will be found to be a purchase or sale.[58]

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53. Gold v. Sloan, 486 F.2d 340, 344-50 (4th Cir. 1973), *cert. denied*, 419 U.S. 873 (1974).

54. See note 8 *supra* and accompanying text.

55. All directors have a fiduciary duty to oversee the affairs of the corporation. Therefore, they must have access to inside information regardless of whether they make use of such access. Officers, as participants in the formulation of policy and management of the corporation, are generally aware of, and have access to, inside information.

Ten-percent shareholders do not always have access to inside information. Nevertheless, Congress included them within the class of persons likely to have access to such information. Unless a demonstrable animosity exists between the shareholders and the corporation, it is difficult for the ten-percent holder to prove lack of access. *See* American Standard, Inc. v. Crane Co., 510 F.2d 1043, 1055 (2d Cir. 1974), *cert. denied*, 421 U.S. 1000 (1975).

56. *See* Sprague Elec. Co. v. Mostek Corp., 488 F. Supp. 842 (N.D. Tex. 1980).

57. The unified approach proposed later in this article satisfies the presently perceived need for the application of the pragmatic approach. *See* Kern County Land Co. v. Occidental Petroleum Corp., 411 U.S. 582, 593-603 (1973). See text accompanying notes 65-79 *infra*.

58. *See* Blau v. Max Factor & Co., 342 F.2d 304 (9th Cir.), *cert. denied*, 382 U.S. 892 (1965); Shaw v. Dreyfus, 172 F.2d 140 (2d Cir.), *cert. denied*, 337 U.S. 907 (1949).

Under the objective approach the most important element in determining when a change in beneficial ownership occurs is the point at which the decision to purchase or sell becomes irrevocable. The objective approach emphasizes this consideration because inside information is useful only in determining when to invest.[59] Inside information can be extremely useful in deciding whether to acquire the ability to profit, but once an irrevocable decision to invest is made, the ability to use inside information has passed.[60] Because section 16(b) is designed to discourage use of inside information for short-term trading, the section ought to apply the moment the use of inside information is possible. Therefore, under the objective approach, the purchase occurs when the decision to invest is irrevocable, even if title will not pass or payment will not be made until some future time.[61]

The important assumption underlying this analysis is the occurrence of an investment decision—a point at which inside information is useful. Some beneficial owners of stock never make the decision to invest and therefore are never able to use inside information. Thus, when courts speak of determining the time of the transfer of beneficial ownership, they are determining the time and occurrence of an investment decision.

If no investment decision is made, courts should not find a purchase or sale, even if a change in beneficial ownership occurs. This analysis is in accord with the pragmatic approach.[62] An important element of an investment decision is control over the timing of the transaction. An investment decision by its nature requires a voluntary acquisition of the ability to profit.[63] If the transaction is involuntary, no decision is made and no opportunity to use inside information exists.[64] Thus, the objective and pragmatic approaches are entirely consistent. Indeed, the terms objective and pragmatic are often merely labels indicating the occurrence of an investment decision (objective) or

59. *See* Prager v. Sylvestri, 449 F. Supp. 425, 432 (S.D.N.Y. 1978) (section 16(b) applies only to speculation—a desire to profit from market activity).

60. *See id.* at 432-33, 437.

61. *See* Heli-Coil Corp. v. Webster, 352 F.2d 156, 168 (3d Cir. 1965) (conversion of preferred stock to common involves an investment decision and is therefore a purchase of common).

62. *See* Blau v. Max Factor & Co., 342 F.2d 304, 308 (9th Cir.), *cert. denied*, 382 U.S. 892 (1965).

63. *See* Petteys v. Butler, 367 F.2d 528, 535-37 (8th Cir. 1966), *cert. denied*, 385 U.S. 1006 (1967); Blau v. Max Factor & Co., 342 F.2d 304, 308 (9th Cir.), *cert. denied*, 382 U.S. 892 (1965). In both *Petteys* and *Max Factor* the courts held that no sale resulted from the conversion of preferred stock into common stock, in part because there was no change in either the amount at risk or the nature of the risk.

64. See note 42 *supra* and accompanying text. *See generally* Portnoy v. Seligman & Latz, Inc., 516 F. Supp. 1188 (S.D.N.Y. 1981).

its nonoccurrence (pragmatic), and the same underlying rationale applies to both approaches.

III. A SINGLE ANALYSIS

As the foregoing discussion suggests, there is no reason to distinguish between ordinary and unorthodox transactions. A single analysis is applicable to all transactions. An insider's access to or use of inside information is no longer at issue, for the proper analysis assumes both access and use.[65] Hence, the analysis of any transaction under section 16(b) can be reduced to three questions:

1. Was there a transfer of beneficial ownership for value?
2. Did the insider make an investment decision?
3. When did the insider make that decision?

If there is no transfer of beneficial ownership for value, section 16(b) is inapplicable.[66] The elements of beneficial ownership are uncertain under current law. Courts have found beneficial ownership to include one or more of the following considerations: an irrevocable obligation to purchase stock;[67] acquisition of the ability to profit;[68] an option to purchase coupled with the power to vote;[69] and the ability to benefit economically from stock even though control over the stock is in another person's hands.[70] The only indication of beneficial ownership relevant to section 16(b) is the ability to profit from the stock.[71] Other considerations, such as the right to vote and the power to dispose of the stock, are irrelevant to a section 16(b) beneficial ownership analysis, though they are useful in determining beneficial ownership in other contexts. Section 16(b) is concerned solely with profits from short-swing trading in stock; unless an insider has the ability to profit

65. See notes 49-57 *supra* and accompanying text.

66. See note 38 *supra* and accompanying text.

67. Blau v. Ogsbury, 210 F.2d 426, 427 (2d Cir. 1954). See note 21 *supra*.

68. Bershad v. McDonough, 428 F.2d 693, 698 (7th Cir. 1970), *cert. denied*, 400 U.S. 992 (1971).

69. Newmark v. RKO Gen., Inc., 425 F.2d 348, 356 (2d Cir.), *cert. denied*, 400 U.S. 854 (1970).

70. Whittaker v. Whittaker Corp., 639 F.2d 516, 525-26 (9th Cir.), *cert. denied*, 50 U.S.L.W. 3375 (U.S. Nov. 9, 1981) (No. 80-1903); Whiting v. Dow Chem. Co., 523 F.2d 680, 688 (2d Cir. 1975).

71. Bershad v. McDonough, 428 F.2d 693, 698 (7th Cir. 1970), *cert. denied*, 400 U.S. 992 (1971). *See* Lynam v. Livingston, 276 F. Supp. 104, 107 (D. Del. 1967) (the most important attribute of an investment is its ability to create a profit). This definition of beneficial ownership does not require the holding of the stock itself. Holding an economic equivalent, such as convertible securities or options, permits an insider to profit by trading in the stock. Alternatively, the ability to profit directly on someone else's holdings will suffice. For an excellent treatment of beneficial ownership for section 16(b) purposes, see Note, *Beneficial Ownership Under § 16(b) of the Securities Exchange Act of 1934*, 77 COLUM. L. REV. 446 (1977).

from trading the stock, he does not own it for purposes of section 16(b).[72]

The existence of an investment decision is crucial to effecting the goal of section 16(b)—the prevention of profit from the use of inside information.[73] If there is no investment decision, there is no ability to use inside information and therefore no opportunity to profit from its use. An investment decision should be defined as the voluntary acceptance or termination of the ability to gain on a security. This concept was implicitly present in cases developing the irrevocable obligation and economic realities analyses of section 16(b).[74] The pragmatic approach arose solely because courts were faced with transactions in which there was no investment decision or there was a decision merely to continue an existing investment.[75]

Finally, the timing of the investment decision is important because Congress limited the reach of section 16(b) to short-swing profits earned from the potential use of inside information. "Short-swing" profit, by definition, is profit made by the investor within six months of his purchase of the securities.[76] Thus, determining the time a purchase or sale occurs is critical to the application of the section.

Because section 16(b) is designed to eliminate the use of inside information, the time of the purchase or sale should coincide with the time of the investment decision. Only at that time can a purchaser or seller use inside information. The transfer of beneficial ownership may follow the investment decision; in such instances the purchase or sale occurs at the time of the investment decision and not at the time of the transfer of beneficial ownership. On the other hand, the transfer of beneficial ownership cannot precede the investment decision. Once a transfer of beneficial ownership occurs, there can be no further use for inside information and no possibility of an investment decision, be-

72. This conclusion does not mean that the power to vote and the power to dispose of the securities are irrelevant to section 16(b) liability. These elements may be at issue when the court determines the existence or time of a section 16(b) purchase or sale. They are not relevant, however, to a determination of whether the insider owned the securities in the first instance.

73. *See* Foremost-McKesson v. Provident Sec. Co., 423 U.S. 232, 254 n.28 (1976) (the crucial point under section 16(b) is when the insider makes the decision to invest, rather than when he makes the technical purchase).

74. *See* Kern County Land Co. v. Occidental Petroleum Corp., 411 U.S. 582, 600 (1973); Petteys v. Butler, 367 F.2d 528, 537 (8th Cir. 1966), *cert. denied*, 385 U.S. 1006 (1967); Ferraiolo v. Newman, 259 F.2d 342, 346 (6th Cir. 1958), *cert. denied*, 359 U.S. 927 (1959).

An early case reaching a similar conclusion is Shaw v. Dreyfus, 172 F.2d 140, 142 (2d Cir.), *cert. denied*, 337 U.S. 907 (1949), in which the court held that a distribution of warrants pro rata to all shareholders is not an insider purchase.

75. See notes 44-46 *supra* and accompanying text.

76. *See* 15 U.S.C. § 78p(b) (1976).

cause such a decision presupposes the ability to voluntarily transfer beneficial ownership.[77] If the transfer has already occurred no decision is left to be made.[78] Generally, the doctrines of irrevocable commitment and economic risk developed under the objective approach are suitable for fixing the time of the investment decision.[79]

IV. APPLICATION OF THE PROPOSED ANALYSIS

Adoption of the proposed analysis would provide greater consistency in some of the more difficult transactions involving section 16(b). This part of the article will analyze some of these transactions.[80]

A. *Mergers*

The typical merger involves the acquisition of one company by another and the receipt of cash or stock in the surviving company by the acquired company's shareholders in return for their shares. Two questions generally arise under section 16(b). First, is the exchange of the acquired company's shares for stock or cash a sale under section 16(b)? Second, is such an exchange a purchase of the surviving company's stock?

1. *Transfer of beneficial ownership*. The exchange of stock in the acquired company for cash or stock in the surviving company is a termination of the ability to gain on the acquired company's stock and is, therefore, a transfer of beneficial ownership. Similarly, acquisition of stock in the surviving company provides the ability to gain on these shares and is, therefore, an acquisition of beneficial ownership.

2. *Investment decision*. Determining the existence of an investment decision is the most difficult facet of a section 16(b) analysis of a merger. The merger itself forces all shareholders to exchange their shares, so in one sense the transfer of beneficial ownership is involun-

77. *See* Prager v. Sylvestri, 449 F. Supp. 425 (S.D.N.Y. 1978). See note 25 *supra*.

78. Courts have missed this point in the past, particularly in the context of employee stock options. For example, in Blau v. Ogsbury, 210 F.2d 426 (2d Cir. 1954), the court found the purchase to have occurred after the insider had already acquired beneficial ownership of the stock. See note 21 *supra*.

79. See notes 21-28 *supra*. Some courts have been overly technical in their application of the irrevocable commitment analysis. *E.g.*, Portnoy v. Revlon, Inc., 650 F.2d 895, 902 (7th Cir. 1981). That the decision is conditioned on certain events out of the control of the insider should not divert a court's attention from the essential point that the decision is made and, from a section 16(b) standpoint, is irrevocable. Thus, inside information can no longer be useful. *But see id.* at 901.

80. An application of the proposed analysis to tax qualified employee benefit plans can be found in Tomlinson, *supra* note 9.

tary. If the transfer is involuntary, no investment decision occurs. Nevertheless, an insider's decision to support a merger is a decision to attempt to terminate an investment in the company. This decision is made voluntarily; insiders are not obligated to support the consummation of a merger.[81] Support of the merger reflects both a decision to terminate investment in the acquired company and a decision to invest in the surviving company. On the other hand, an insider who opposes a merger has not made an investment decision because his exchange of shares is involuntary.

3. *Time of investment decision.* A merger cannot be consummated until the shareholders of the acquired company formally approve the merger. Until the time of the shareholders' vote, insiders are free to change their minds about their decision to relinquish the acquired company's securities in return for those of the surviving company. Once the insiders vote their shares, however, they are irrevocably bound by their decision. The day of the vote is the last day that inside information is useful; thereafter the insider cannot affect events, and his stock must be exchanged. Therefore, the day of the shareholders' vote is the day the investment decision occurs although it may precede the actual exchange of stock by several days or weeks. Accordingly, it is also the day of the section 16(b) purchase and sale.

Finding that the investment decision occurs when shareholders vote on the merger will seldom cause an insider in favor of a merger to vote against the transaction. Under section 16(b), only insiders who purchased stock within six months of the shareholders' vote can be liable for profits in a merger. Although merger negotiations do not necessarily take six months, mergers are not quick transactions, and few insiders unaware of merger possibilities are likely to purchase stock shortly before merger negotiations begin.

4. *An example.* The proposed analysis can be illustrated by applying it to *Gold v. Sloan*.[82] In *Gold* the defendants, Scurlock, Rumbel, Sloane, and Sloan, were insiders of Atlantic Research Corporation. Atlantic was acquired by the Susquehanna Corporation pursuant to a merger agreement negotiated by Sloan and approved by the Atlantic shareholders. Scurlock, Rumbel, and Sloane did not participate in the negotiations. Apparently the defendants all voted in favor of the merger. All the defendants became insiders of Susquehanna upon con-

81. An insider may be required to negotiate a merger based on an unsolicited merger proposal if he deems it in the shareholders' best interests.

82. 486 F.2d 340 (4th Cir. 1973), *cert. denied*, 419 U.S. 873 (1974).

court achieved this result by absolving from liability those defendants without access to inside information.

This approach confuses the analysis of purchases and sales[89] and is inconsistent with the statute itself.[90] Actual access to inside information is irrelevant to section 16(b). The statute presumes access to inside information based on the insider's relationship to the issuer.[91] The court should have first determined whether the defendant was an insider and then applied the statute. The court should have found that none of the defendants were insiders of Susquehanna before the merger and therefore the purchase of Susquehanna stock was not subject to section 16(b). Although this result would have been inconsistent with earlier decisions, the rationale underlying those cases has never been very persuasive.[92] Section 16(b) is designed to prevent short-swing trading by persons with a particular relationship to the issuer; purchases made when that relationship (officer, director, or ten-percent shareholder) does not exist should not be subject to the statute.[93]

Even though the defendants were insiders when the subsequent sales were made and inside information may have been used in the determination to sell, the purchases should not be subject to section 16(b). The statute often does not apply when inside information might be useful.[94] It applies only to short-swing transactions involving both a purchase and a sale made while a person is an insider; the statute ought not apply to short-swing transactions involving only a purchase or only a sale made while a person is an insider.[95]

Neither the existing dual analysis nor this article's proposed single analysis addresses questions of insider status. These questions are irrelevant to whether a transaction is deemed a purchase or sale. Under the proposed analysis all of the *Gold v. Sloan*[96] defendants would be found to have purchased and sold Susquehanna stock. Each acquired and disposed of beneficial ownership for value. Each decided to invest in

89. See text accompanying notes 49-57 *supra*.

90. See note 19 *supra* and accompanying text.

91. Section 16(b) was enacted "[f]or the purpose of preventing unfair use of information which may have been obtained by [an insider] by reason of his relationship to the issuer . . . ." 15 U.S.C. § 78p(b) (1976). *See* Whittaker v. Whittaker Corp., 639 F.2d 516, 521-22 (9th Cir.), *cert. denied*, 50 U.S.L.W. 3375 (U.S. Nov. 9, 1981) (No. 80-1903).

92. *See, e.g.*, Blau v. Allen, 163 F. Supp. 702 (S.D.N.Y. 1958).

93. *See* Foremost-McKesson, Inc. v. Provident Sec. Co., 423 U.S. 232, 242-43 (1976) (person not a 10% holder prior to a purchase is not subject to section 16(b) for a transaction that causes his holdings to reach 10%).

94. *See* Whittaker v. Whittaker Corp., 639 F.2d 516, 522 (9th Cir.), *cert. denied*, 50 U.S.L.W. 3375 (U.S. Nov. 9, 1981) (No. 80-1903) and cases cited therein.

95. *See* Portnoy v. Seligman & Latz, Inc., 516 F. Supp. 1188 (S.D.N.Y. 1981).

96. 486 F.2d 340 (4th Cir. 1973), *cert. denied*, 419 U.S. 873 (1974).

Susquehanna stock by supporting the merger, and later to terminate his beneficial ownership of the Susquehanna stock. Thus, all defendants purchased Susquehanna stock on the date of the shareholders' vote and sold it less than six months later. Assuming the defendants were insiders of Susquehanna, all should have been liable under section 16(b) because all sold and purchased within six months.

B. *Stock Options*

1. *Transfer of beneficial ownership*. Most courts have held that the acquisition of a stock option is not a purchase of the underlying stock until the option is exercised.[97] Under this article's proposed analysis, acquisition of the option is the acquisition of beneficial ownership of the underlying stock. The holder of the option has the ability to gain on the underlying stock. The exercise of the option does not change the option holder's ability to profit on the stock because, whether the insider holds the option or the stock, potential profit depends solely on the price of the stock. By exercising the option, the holder accepts the risk of losing the money he pays for the stock. The most important element of beneficial ownership, however, is the ability to gain on the stock, not the ability to lose; therefore, acquisition of the option is acquisition of beneficial ownership of the underlying stock.

2. *Investment decision*. When an insider purchases an option[98] an investment decision has occurred. The insider has voluntarily acquired the ability to gain on the underlying security. Employee stock options present a more difficult question. Generally, it is within the sole discretion of the board of directors to award such options. Because directors eligible to receive options commonly are excluded from the board's compensation or option committee, these insiders cannot cause options to be awarded to themselves. Thus, option transactions are involuntary, and inside information cannot benefit the insider. Accordingly, there is no section 16(b) purchase because no investment decision is made. The public shareholder also does not need the statute's protection in this instance. If significant nonpublic information exists that

97. *See, e.g.*, Silverman v. Landa, 306 F.2d 422, 424 (2d Cir. 1962); Stella v. Graham-Paige Motors Corp., 232 F.2d 299, 301 (2d Cir.), *cert. denied*, 352 U.S. 831 (1956); Matas v. Siess, 467 F. Supp. 217, 222 (S.D.N.Y. 1979); Levy v. Seaton, 358 F. Supp. 1, 4 (S.D.N.Y. 1973). *But see* Newmark v. RKO Gen., Inc., 425 F.2d 348, 356 (2d Cir.), *cert. denied*, 400 U.S. 854 (1970).

98. The major types of options are "call" options (the right to purchase stock at a fixed price for a specified period) and "put" options (the right to sell stock at a fixed price for a specified period). Many variations of these types of options exist; for example, employee stock options are a type of call option. *See generally* Note, *supra* note 9.

would make issuance of the options unfair, the board will not issue them.

Just as the exercise of the option is not a transfer of beneficial ownership for section 16(b) purposes, it is also not an investment decision. This conclusion is not intuitively obvious because by exercising the option the insider places more cash at risk. Nevertheless, the decision to exercise the option is a decision to continue an existing investment in stock. Because he holds the option, the insider already has the ability to gain on the stock; buying the stock does not change his ability to profit. Section 16(b) does not apply to decisions to continue an investment, notwithstanding that inside information is obviously helpful in making such a decision.

The decision to sell the option or the stock purchased by exercise of the option is, however, a voluntary termination of the ability to gain and, accordingly, an investment decision. A stock sale within six months of the purchase of an option would therefore be a purchase and sale for purposes of section 16(b).[99]

3. *Time of investment decision.* Generally the investment decision occurs, if at all, when the option is acquired. If the option is held for more than six months, profit realized on its sale is not within section 16(b). Similarly, if the option is exercised but the stock is not sold until six months or more from the date of the grant of the option, profit is characterized as long-term and not subject to section 16(b).[100]

4. *An example.* A good illustration of the proposed analysis is its application to *Newmark v. RKO General, Inc.*[101] RKO controlled Frontier Airlines and in April 1967 negotiated a merger of Frontier Airlines with Central Airlines. Under the proposed merger, holders of Central Airlines' stock were to receive a share of Frontier stock for every three and one-half shares of Central stock they held. Essentially concurrent with the execution of the merger agreement, RKO acquired an option to purchase forty-nine percent of the outstanding shares of Central for a fixed price. The option was in the form of a binding purchase contract, but, as the court noted, contained sufficient contingencies to be an option.[102] Less than six months after acquiring the option, RKO purchased the option stock. The merger also was effected

99. *See, e.g.*, Portnoy v. Seligman & Latz, Inc., 516 F. Supp. 1188 (S.D.N.Y. 1981); Portnoy v. Texas Int'l Airlines, Inc., [1980 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 97,889 (N.D. Ill. 1980).

100. *See* Rosen v. Drisler, 421 F. Supp. 1282 (S.D.N.Y. 1976).

101. 425 F.2d 348 (2d Cir. 1970), *cert. denied*, 400 U.S. 992 (1971).

102. 425 F.2d at 352.

within six months of the acquisition of the option, and RKO exchanged its Central shares for Frontier shares.

Using the pragmatic approach, the Court of Appeals for the Second Circuit held that both the acquisition and the exercise of the option to buy the Central stock were purchases of that stock.[103] In addition, the court held that the exchange of the shares pursuant to the merger was a sale of the Central shares; hence RKO was liable to Central for its profits.[104]

The court's conclusion that the Central shares were purchased twice is illogical. The court reached this conclusion because of its evident desire to hold RKO liable. RKO could not be held liable unless it had been an insider both at the time of purchase and at the time of sale.[105] RKO could not be considered an insider at the time of its acquisition of the option to purchase Central shares.[106] To eliminate this problem, the court held that the option contract was a transfer of beneficial ownership of more than ten percent of the shares to RKO, and that RKO, in exercising that option, was a purchaser of shares while an insider.[107] The court failed to explain how RKO could acquire beneficial ownership of the same stock twice.

Furthermore, the court made no persuasive attempt to explain how RKO's acquisition of the option conferred beneficial ownership. All previous cases in the Second Circuit had held that options do not confer beneficial ownership of the underlying stock to the option holder.[108] The court stated only that the previous cases involved options that conferred no ability to acquire inside information, but that RKO's did.[109] Nowhere did the court explain how the ability to acquire inside information affects the acquisition of beneficial ownership of stock.[110] The court stated that the ability to profit on the stock constitutes beneficial ownership and then asserted that, notwithstanding

103. *Id.* at 354, 356.

104. *Id.* at 354.

105. *See* 15 U.S.C. § 78p(b) (1976).

106. Whether a purchase causing a person to reach the 10% plateau is subject to section 16(b) was formerly a subject of intense debate. The Supreme Court concluded ultimately that such a purchase is not subject to section 16(b). Foremost-McKesson, Inc. v. Provident Sec. Co., 423 U.S. 232, 254 (1976).

107. 425 F.2d at 356.

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

109. 425 F.2d at 356.

110. The Supreme Court has indicated that lack of access to inside information may imply that a transaction is not a purchase or sale. Kern County Land Co. v. Occidental Petroleum Corp., 411 U.S. 582, 596 (1973). The Supreme Court did not indicate that access to inside information has any bearing on beneficial ownership.

this test, an option not conferring on its holder the ability to acquire inside information could not confer beneficial ownership of the underlying stock.[111]

The analysis presented in this article avoids the result that the court reached in *Newmark*. Under the proposed analysis, the acquisition of the option was the acquisition of beneficial ownership of the underlying stock because it was the acquisition of the ability to gain on the stock. The acquisition was a section 16(b) purchase because it involved an investment decision. The purchase occurred on the date that RKO acquired the option. The exercise of the option was not a purchase of the stock because RKO already owned the stock. The exchange of the stock in the merger was a sale for the reasons explained above in the discussion of mergers.[112] Because RKO was not an insider when it purchased the stock, however, its purchase could not have been matched to the sale and no liability would have been incurred.

V. CONCLUSION

The development of two doctrines—the objective and pragmatic approaches—under which courts apply section 16(b) has made analysis of insider stock transactions unnecessarily complex. It is difficult for an insider to predict with any certainty whether his transaction will be identified as an unlawful purchase and sale; such uncertainty tends to defeat the prophylactic purpose of the statute. Moreover, the confusion is unnecessary; for analysis of the two approaches reveals that they are based on common principles. This article has articulated those principles and has proposed a unified approach for analysis of all insider stock transactions. Under this approach, all transactions may be identified as lawful or unlawful by application of the following three-question analysis:

1. Was there a transfer of beneficial ownership for value?
2. Did the insider make an investment decision?
3. When did the insider make that decision?

Adoption of the unified approach to section 16(b) analysis would assist the courts in effectively penalizing and deterring abuse of inside information, because the approach focuses most clearly on the conduct that the statute was intended to prevent.

111. 425 F.2d at 353, 356.

112. See text accompanying notes 80-96 *supra*.