[Vanderbilt Law Review](https://scholarship.law.vanderbilt.edu/vlr)

Volume 22
Issue 5 *Issue 5 - October 1969*

Article 3

10-1969

Insider Liability for Short-Swing Profits Pursuant to Mergers and Related Transactions

James P. Hemmer

Insider Liahility for Short-Swing Profits Pursuant to Mergers and Related Transactions

*James P. Hemmer**

This article considers the problems presented by the application of section 16(b) of the Securities Exchange Act of 1934 to corporate merger transactions. Mr. Hemmer argues that the "matching across" proposal, which has been suggested by some commentators, should not be applied to the merger situation. Instead, the author advocates that the "possibility of abuse" test, which the courts have applied to conversion transactions, should also be applicable to the corporate merger. Mr. Hemmer feels this approach will prevent the abuses for which section 16(b) was enacted and, at the same time, provide the courts with a flexible test for this complex area.

Corporate merger activity presently is at its highest point in the history of American business. The number of transactions in 1968 exceeded the previous year's total by approximately 50 percent. For the members of the corporate bar whose practice is concerned with insider short-swing transactions, this rise in the number of consolidation transactions has substantially increased the consternation which that segment of the bar experiences when assessing the impact of recapture provisions of section 16(b) of the Securities Exchange Act of 1934[1] upon the insider's merger exchange of shares.

Traditionally, it has been the rule for practitioners to assume almost automatically that a merger exchange of shares constitutes a "sale" of the securities of the non-survivor and a "purchase" of those of the survivor. This assumption has never been adequately documented with decisional law, an SEC ruling, or even with law review commentary. In juxtaposition to the traditional assumption, the suggestion is becoming popular that it should be possible to follow the insider's transactions in the "underlying security" so as to match his pre-merger activities in the sharcs of the non-survivor with his post-merger speculations in the stock of the survivor.[2] Although this so-

* Member of the Chicago Bar.

1. 15 U.S.C. § 78p(b) (1964).
2. Even a very superficial glance at the two assumptions here is sufficient to indicate that

called "matching across" proposal is without foundation in either decisional law or SEC rulings, the inadequate documentation of the traditional assumption has not been sufficient to arrest its popularity.

The purpose of this article is to examine and explore the law developed under section 16(b) and to discuss its applicability to merger transactions. It is hoped that this analysis will clarify the confusion generated by the "matching across" proposal and lead to the adoption of a more flexible approach to these problems.

I. SECTION 16(b) OF THE SECURITIES EXCHANGE ACT AND ITS CASE LAW

As in the case of most statutes, the crux of the problem rests in the language of the statute itself. Section 16(b) of the Securities Exchange Act provides that "any profit realized by [the corporate insider] 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" is subject to recapture by the corporation.[3] On its face, the language of this statute limits its penalty to transactions where there has been a short-swing purchase/sale.

The first major case to interpret the statute, *Smolowe v. Delendo Corp.*,[4] set down rigorous criteria which subsequently have become the recognized methodology, both for the imposition of section 16(b) liability and for the computation of the recoverable profit. First, liability is to be imposed "automatically" or "mechanically" whenever it is shown that the insider purchased and sold within a period of six months, irrespective of either the good faith of the insider or the lack of abuse of inside information with regard to the short-swing transaction. The point here is that "good faith" is not a relevant question with respect to section 16(b). The recapture penalty is to be imposed prophylactically in order to discourage all insider short-swings. Second, the profit recoverable is to be computed by means of "an arbitrary matching to achieve the showing of a maximum profit," even if the insider purchased one certificate and sold another and can show "that he is holding the purchased security for sale after six months."

---

the problem is not simply that of plaintiff's bar versus defendant's bar. While the traditional assumption provides fewer possibilities for "matching," it does provide for recapture upon the merger exchange. Accordingly, without a given factual situation, it is almost impossible to determine which alternative would be most beneficial to either plaintiff or defendant.

3. 15 U.S.C. § 78p(b) (1964).

4. 136 F.2d 231 (2d Cir.), *cert. denied*, 320 U.S. 751 (1943).

The court rejected any identification of certificates actually purchased and sold for two reasons. First, if the insider conducting the speculations had a reserve of stock from which to draw upon, an identification requirement would allow him to circumvent the recapture penalty entirely, simply by selecting those certificates which he had held for more than six months as the certificates to be used for the second step of his short-swing. Second, identification would as a practical matter prevent the recapture of profits from any sale followed by a purchase because it would be necessary in such cases to make the near impossible showing of the insider's subjective intent to conduct the connected phases of this type of short-swing.[5]

Unfortunately, while the two-fold pronouncement of *Smolowe* efficiently effectuates the statute when there is an ordinary purchase/sale situation, problems arise when that two-fold theory is applied to situations in which one aspect of the short-swing transaction is not amenable to the common law definition of the term "purchase" or "sale." These situations include reclassifications, conversions, and merger exchanges. The problem is again implicit in the language of the statute itself. While section 16(b) is limited in its language to "purchases" and "sales," the definitions of "purchase"[6] and "sale"[7] in the 1934 Act may be construed to include many types of transactions not amenable to the common law definitions of those terms.

The first case to deal with this problem was *Park & Tilford, Inc. v. Schulte*,[8] which involved a conversion transaction. The issue was whether a conversion of preferred stock into common was a "purchase" of the common stock matchable with the insider's sale of the common. The Second Circuit, applying the rationale of *Smolowe*, interpreted the broad definitions of the terms "purchase" and "sale" to require the application of section 16(b) to any "acquisition of a security." Judge Clark stated:

> We think a conversion of preferred into common stock followed by a sale within six months is a 'purchase and sale' within the statutory language of section

5. Western Auto Supply Co. v. Gamble-Skogmo, Inc., 348 F.2d 736 (8th Cir. 1965), *cert. denied*, 382 U.S. 987 (1966), reaffirmed *Smolowe's* "prophylactic" non-identification rule despite the fact that it had been established that the actual shares purchased within the six-month period in question had not been sold.

6. 15 U.S.C. § 78c(a)(13) (1964) provides as follows: "The terms 'buy' and 'purchase' each include any contract to buy, purchase, or otherwise acquire."

7. 15 U.S.C. § 78c(a)(14) (1964) provides as follows: "The terms 'sale' and 'sell' each include any contract to sell or otherwise dispose of."

8. 160 F.2d 984 (2d Cir.), *cert. denied*, 332 U.S. 761 (1947).

16(b). Whatever doubt might otherwise exist as to whether a conversion is a 'purchase' is dispelled by definition of 'purchase' to include 'any contract to buy, purchase, or otherwise acquire.'[9]

Shortly thereafter, in the first merger case, *Blau v. Hodgkinson,*[10] a federal district court focused upon the *Park & Tilford* statement that section 16(b) is to be applied to each "contractual" disposition of a security, and held that a merger exchange of shares results in a "purchase" of the surviving issuer's stock. Today, this holding is still the only real authority for the proposition that an exchange of stock pursuant to a merger is cognizable "automatically" for section 16(b) purposes.[11]

The arbitrariness of the *Hodgkinson* holding is unfortunate because, at approximately the same time, the Second Circuit was beginning to draw away from *Park & Tilford's* mechanical approach. In two cases, pro rata transactions were held not to be purchases.[12]

It was not until the next major conversion case that the *Park & Tilford* rationale was directly confronted. In *Ferraiolo v. Newman,*[13] Judge Stewart of the Sixth Circuit rejected the *Park & Tilford* rationale in favor of an approach which compares the facts of each case against the test of whether "the transaction is of a kind which can possibly lend itself to the speculation encompassed by section 16(b)."[14] Broadly, Judge Stewart's rationale was that when one aspect of the short-swing transaction is not amenable to the common law definition of the term "purchase" or "sale," that aspect will be considered a "purchase" or "sale" for section 16(b) purposes only if the transaction possibly could involve the kind of abuse which section 16(b) was designed to prevent.[15]

Since *Ferraiolo* was handed down in 1958, three of the four circuits which have considered similar situations have adopted its approach. The Ninth Circuit held a conversion of common stock into class A stock not to be a "purchase" of the class A stock because it

9. *Id.* at 987.

10. 100 F. Supp. 361 (S.D.N.Y. 1951).

11. In Blau. v. Lamb, 242 F. Supp. 151 (S.D.N.Y. 1965), *rev'd on other grounds*, 363 F.2d 507 (2d Cir. 1966), *cert. denied*, 385 U.S. 1002 (1967), the district court also held, on the basis of *Park & Tilford*, that the exchange was a "purchase;" however, the circuit court explicitly declined to pass upon this issue since it was not contested upon appeal.

12. Shaw v. Dreyfus, 172 F.2d 140 (2d Cir.), *cert. denied*, 337 U.S. 907 (1949) (distribution of warrants on per share basis); Roberts v. Eaton, 212 F.2d 82 (2d Cir.), *cert. denied*, 348 U.S. 827 (1954) (pro rata recapitalization).

13. 259 F.2d 342 (6th Cir. 1958), *cert. denied*, 359 U.S. 927 (1959).

14. *Id.* at 345.

15. *Id.* at 346.

did not interrupt the continuity of the insider's investment.[16] The Second Circuit held a conversion of preferred into common not to be a "sale" of the preferred because of the economic equivalence of the preferred and common, the unchanged investment position of the insider, and the insider's failure to dispose of the underlying security within six months of its acquisition.[17] The Eighth Circuit held a conversion not to be a "purchase" when the underlying security had not been sold within six months of the purchase of the convertible.[18]

The only dissenting circuit, the Third Circuit, handed down an en banc decision in *Heli-Coil v. Webster,*[19] which held that when an insider converted debentures four months after their purchase and sold the common four months later, the conversion was a sale of the debentures and a purchase of the common. Four judges dissented, at least in part, from the majority opinion. Significantly, the majority in *Heli-Coil* relied upon the Second Circuit opinion in *Park & Tilford.* One year later, in *Blau v. Lamb,* the Second Circuit implicity rejected the broad dictum of *Park & Tilford* and, in a footnote to the opinion, noted that it was adopting the *Ferraiolo* approach.[20] It pointed out that its decision was in conformity with the SEC's recently adopted rule 16b-9,[21] which exempts conversions from the operation of section 16(b) if the original acquisition and ultimate disposition are at least six months apart. Thus, the holding in *Heli-Coil* is a minority view based upon a broad dictum which has been disapproved even in its own circuit.[22]

II. EFFECT OF THE CONVERSION CASES UPON THE APPLICABILITY OF SECTION 16(b) TO MERGERS

When applied to mergers, this case development should effect no greater change than it did with respect to the conversion situations out

16. Blau v. Max Factor & Co., 342 F.2d 304 (9th Cir. 1965).
17. Blau v. Lamb, 363 F.2d 507 (2d Cir. 1966), *cert. denied,* 385 U.S. 1002 (1967).
18. Petteys v. Butler, 367 F.2d 528 (8th Cir. 1966), *cert. denied,* 385 U.S. 1006 (1967).
19. 352 F.2d 156 (3rd Cir. 1965).
20. 363 F.2d at 518-19 n.15.
21. The SEC rule was itself in response to the muddled *Heli-Coil* decision, wherein the SEC had urged—as amicus curiae—the position adopted by the majority. The SEC changed its position on the theory that these transactions "are not comprehended within the purpose of section 16(b)." 17 C.F.R. § 240.16b-9 (1968).
22. In this connection, it is interesting to note that a recent district court decision in the Third Circuit, *Lynam v. Livingston,* CCH FED. SEC. L. REP. ¶ 92, 146 (D. Del. (1967)) read the *Heli-Coil* decision as limited to voluntary conversion situations and, in effect, declined to follow its liability rationale.

of which it arose. In the past, courts have made no distinction in liability theory between reclassifications, mergers, and conversions. Accordingly, the current view should be just as relevant to mergers as it is to the conversion situations out. Therefore, the "actual possibility of abuse" test should be substituted for *Blau v. Hodgkinson's* categorical classification. Under this approach, a merger exchange will be subject to section 16(b) recognition only if it involves a short-swing speculation presenting an actual possibility of a misuse of inside information.[23]

The adoption of the "possibility of abuse" test would cnd the confusion generated by the arbitrary holding of *Heli-Coil v. Webster,* the blanket exemption of conversion exchanges under rule 16b-9, and the inconsistencies of the *Blau v. Lamb* decision. Essentially, it is these trends that have provided the basis for the suggestions that the courts should accord blanket non-recognition to the merger exchange, should address themselves to the insider's transactions in the underlying security, and should match the insider's pre-merger transactions in the non-survivor's securities with post-merger ones in those of the survivor.[24]

The arbitrariness of the *Heli-Coil* decision is reflected by the damages awarded. In order to mitigate the harshness of its "automatic" imposition of liability upon both the conversion and the subsequent sale, the Third Circuit refused to uphold the district court finding that the insider was liable for both the profit upon the conversion "sale" of the debentures and the sale profit upon final disposition of the common.[25] Rather it held the insider liable only for the latter, on the theory that any "profit" which accrued upon conversion was a "paper profit" held at the risk of the market and not "profit realized" as required by the language of section 16(b). A criticism of this point is that section 16(b) liability should not turn upon the fortuity of whether or not the speculator decides to close out his speculations. If the exchange is part of a speculative short-swing, it is the type of transaction section 16(b) is designed to prevent

23. Even before *Blau v. Lamb* and *Petteys v. Butler,* there was some authority for this type of approach in the merger area. *See* Marquette Cement Mfg. Co. v. Andreas, 239 F. Supp. 962 (S.D.N.Y. 1965) (an exchange of assets case which in fact found the insider liable because of the actual possibility of abuse present in the transaction). *See also* Newmark v. RKO General Inc., 294 F. Supp. 358 (S.D.N.Y. 1968).

24. *See, e.g.,* Lang & Katz, *Liability for Short-Swing Trading in Corporate Reorganizations,* 20 SW. L.J. 472 (1966); Cook & Feldman, *Insider Trading Under The Securities Exchange Act,* 66 HARV. L. REV. 612 (1953).

25. 352 F.2d at 167-68.

regardless of whether or not the insider subsequently "holds" or "sells."

As noted earlier,[26] rule 16b-9 was adopted to avoid the *Heli-Coil* result. Additionally, its exemption of all conversions in which the original acquisition and ultimate disposition are more than six months apart was designed to provide an arbitrary rule of thumb reminiscent of *Park & Tilford*, in order to avoid the "subjective" standard of proof required by the "actual possibility of abuse" cases. In practice, however, the regulation presents more difficulties than are implicit in *Heli-Coil* and imposes a more arbitrary standard upon the corporate insider than would the application of *Park & Tilford.*

Rule 16b-9 exempts the "acquisition" and "disposition" involved in the conversion exchange when the insider who is converting does not have opposite transactions—independent of the conversion itself—in the convertible security and the underlying conversion security within six months of the conversion. The anomaly of this regulation is seen readily in the context of a few of its applications. For example, if an insider acquired convertible preferred stock and had no transactions in that preferred or in any other securities of the issuer for six months, the conversion acquisition/disposition would be exempt and the insider would not have any matchable transactions if he subsequently within six months either:

(1) converted the preferred and sold the underlying common, or
(2) sold some convertible preferred, converted the rest, and sold the underlying common, or
(3) converted the preferred, and purchased some more convertible preferred.

The conversion acquisition and disposition would *not* be exempt to the same insider, and he would have matchable transactions if he either:

(4) converted the preferred, sold the underlying common, and purchased some more convertible preferred, or
(5) sold some preferred, converted the rest, and purchased some common.

Of course, no one should disagree with the result in (4) above. There is a short-swing speculation in the preferred—a purchase and a conversion "sale." But the same is true in (3), and there the speculation is exempted by rule 16b-9. The only difference is that in (4) the insider closed out a part of his investment by disposing of the common, whereas in (3) he did not.

If retention of the investment is a reason for distinguishing

26. See note 21 *supra* and accompanying text.

between the speculation in (3) and (4), it is also a reason for totally denying the exemption to the speculation in the common in (1) and partially denying it in (2)—both of which rule 16b-9 exempts entirely despite the short-swing speculation in the underlying common.

The most difficult transaction to understand is (5), which falls squarely within rule 16b-9(a)(ii) as non-exempt. The transaction consists of two sales of preferred and two purchases of common. The only matching possibility is to pair the sales of preferred directly with the purchases of common. *Blau v. Lamb* does contain dicta which support the reverse of this proposition (*i.e.*, purchase of preferred followed by a sale of common),[27] but the *Blau v. Lamb* dicta are directed at a situation which is an "in-and-out" speculation. This is not the case in (5) because the insider has not disposed of his investment.

This analysis indicates that the regulation does not clarify the insider trading rules. Its simplistic solution is extremely arbitrary. While such arbitrariness may be understandable when it takes the form of an administrative regulation designed to establish clearly delineated boundaries for one particular type of situation, it is hardly the type of model which should be employed in fashioning the judicial guidelines for other situations which involve quite different considerations.

The *Blau v. Lamb* decision is even more of a problem. At the outset of the opinion, the Second Circuit stated that it was adopting the *Ferraiolo* "possibility of abuse" approach. The court did not overrule *Park & Tilford*, but indicated that the imposition of liability in that case could be explained by the insider's absolute control.[28] This in effect applies a "possibility of abuse" rationale to the *Park & Tilford* fact situation. Subsequently, the court stated:

> We think that in cases like the present involving the purchase of a convertible security and its subsequent conversion, the issue should be whether the underlying security has been sold within six months from the acquisition of the convertible security.[29]

This statement is in direct contradiction to the court's earlier adoption of *Ferraiolo* and is the only judicial pronouncement providing explicit authority for the "matching across" proposal.

The statement, however, must be read in light of the court's

27. 363 F.2d 507 (2d Cir. 1966).

28. This same sort of application is found in *Lynam v. Livingston's* reading of *Heli-Coll.* See note 22 *supra*.

29. 363 F.2d at 525.

refusal to declare its position regarding the "economic equivalence" theory which is the *sine qua non* for a finding of non-recognition on a conversion exchange—a finding basic to the "matching across" proposal. Rather, the court proposed three hypothetical situations and left open the question whether the conversion itself in any of the three could constitute one part of a speculation subject to section 16(b).[30] One involved a conversion of preferred and a subsequent purchase of preferred. The question left unresolved was whether this could constitute speculation in the preferred. The court also left unresolved the dual question whether a sale of common within six months before or after a conversion "purchase" of common could in either case constitute speculation in the common.

The inference to be drawn from these unresolved questions must be that *Blau v. Lamb* is not authority for the suggestion that there is to be blanket non-recognition of conversion (or merger) exchanges. Further, the court's discussion of the three hypotheticals in terms of a speculation in a particular security, whether preferred or common, militates against any implication that it should be possible to match non-identical securities of even a single issuer. This conclusion is reinforced by the court's rejection of the claim that "equal treatment" must be accorded to both aspects of the conversion exchange.[31]

Immediately following these statements, however, the court held that when the original acquisition and ultimate disposition occur within a period of six months, the entire profit of the insider should be recaptured on either of two theories:

> either on the theory that the accrued profit on the preferred as well as the profit on the common has been realized, 'within (a) period of less than 6 months' for purposes of the statute, or else upon the theory that, under such circumstances, the purchase of a convertible preferred may be treated as a purchase of common stock, for the statute defines 'purchase' as including 'any contract to buy, purchase or otherwise acquire,' and the purchase of the convertible security includes a contractual right to acquire the conversion security. This view of the statute is reflected in amended rule 16b-9 recently adopted by the Securities & Exchange Commission . . . .[32]

---

30. It is interesting to note that the short-swing speculations in each of these hypotheticals have been exempted from section 16(b) by Reg. 16b-9 in certain situations.

31. The court stated: "[I]f . . . a conversion followed by a sale of the common facilitates speculation in the common, this is . . . not, standing alone, a reason for concluding that the conversion should be considered a Section 16(b) 'sale' of the preferred. In order to support this latter conclusion it must be established that the conversion in some way facilitated short-term speculative trading in the preferred." 363 F.2d at 524.

32. *Id.* at 525.

Of course, this resolution does give effect to the SEC's newly promulgated rule—a laudable aim. But the language of the second alternative—the alternative which allows a direct matching of the purchase of preferred with the sale of common—is the old language of *Park & Tilford,*[33] of "purchase" and "sale" which arbitrarily applies the statutory definitions to the recapture scheme of section 16(b). Both the *Ferraiolo* decision and the discussion in the *Blau v. Lamb* opinion prior to the actual decision recognized the capriciousness inherent in this application. One year later, however, *Petteys v. Butler* followed this same approach immediately after noting that it too was adopting the *Ferraiolo* rationale.[34]

The result is that these cases provide a contradictory rationale. They pay lip service to the "possibility of abuse" reasoning in *Ferraiolo* and to that decision's rejection of the arbitrary "definition" approach of *Park & Tilford,* and in the discussions in their opinions before the actual decisions they do stress the significance of the "possibility of abuse" test.[35] At the same time, however, they give effect to rule 16b-9, a regulation designed to avoid the problems caused by *Heli-Coil's* confusion of liability theory and profit recovery formula. In so doing, they unintentionally provide a methodology that is more arbitrary than *Park & Tilford,* one which confuses liability theory and profit recovery formula at least as much as did *Heli-Coil,*[36] and makes the factual inquiry of *Ferraiolo* superfluous.[37]

III. THE MERGER SHORT-SWING TRANSACTION

This inconsistency in prior authority would not cause any

33. *See* Park & Tilford, Inc. v. Schulte, 160 F.2d 984 (2d Cir. 1947), and text accompanying note 9 *supra.*

34. 367 F.2d at 537-38.

35. The statement of the Second Circuit in this regard is unequivocal: "To be sure, the theory of regulation underlying Section 16(b)'s regulatory mechanism provides a sufficient reason for refusing to examine the details of transactions once it has been determined that they might possibly have served as vehicles for unfair insider trading . . . . [B]ut . . . in order to avoid 'purposeless harshness' a court should first inquire whether a given transaction could possibly tend to accomplish the practices Section 16(b) was designed to prevent." 363 F.2d at 519.

36. It is to be recognized that both *Blau v. Lamb* and Reg. 16b-9 contain an "all or nothing" profit recovery formula corresponding to their "all or nothing" liability theory. This profit formula, as well as the liability theory upon which it is based, is not consistent with the two-fold methodology established by *Smolowe.* See text accompanying note 4 *supra.*

37. If there is to be recognition of a conversion exchange when the insider has both a purchase and sale within six months of the conversion, and non-recognition when the insider does not, it is difficult to envision any situation not already within the purview of these two possibilities.

insurmountable problems if the only situations to which it were applied were the simple purchase/conversion/sale transactions found in *Lamb* and *Petteys*.[38] Serious problems arise, however, when this theory is applied in the merger area to situations analogous to those in *Lamb* and *Petteys*, or to those in which the insider is involved in a multiple series of transactions within six months involving distinct securities of different issuers. As an example, take the merger situation most analogous to *Lamb* or *Petteys*—when an insider of the survivor purchases securities of the non-survivor prior to announcement of the proposed merger at a price below the merger exchange value, exchanges the non-survivor's securities for those of the survivor in the merger, and then has no transactions in the securities of the survivor for a period of six months. This situation clearly contains the potential for abuse, and in the recent case of *Newmark v. RKO General, Inc.*,[39] which involved similar facts, the district court found the merger exchange to be a "sale" of the non-survivor's securities and imposed liability. Significantly, the defendant's unsuccessful argument centered on the contention that a merger exchange is tantamount to a conversion of convertible securities and is therefore exempt from section 16(b).

The defendant's other principal argument in *Newmark* was that the survivor's and non-survivor's securities were virtually "economic equivalents,"—the factor on which most courts have relied in determining a conversion of convertible securities to be exempt from section 16(b). The district court rejected this argument, noting that it is questionable whether an exchange of two different issuers' securities could ever present the economic equivalence issue. In the case of convertible securities the insider simply receives a different form of the same participation in his issuer, but in a merger the insider receives a different form of a different participation in what is essentially a new issuer.[40]

It is this factor which makes it impractical to apply in the merger area an automatic imposition of liability when there is a purchase and a sale of the underlying security within six months. In

---

38. In this respect, it is to be recognized that in both *Lamb* and *Petteys*, the invocation of the SEC's Reg. 16b-9 made the conversion exchanges of the insider-defendants non-recognition transactions—the same result which ensued from each court's conclusion based upon the "possibility of abuse" analysis which each had undertaken immediately before their respective "invocations."

39. 294 F. Supp. 358 (S.D.N.Y. 1968). The defendant insider of the survivor was a 10% beneficial owner of the non-survivor.

40. *Id.* at 362-63.

the case of a merger exchange, there is no "underlying security" equivalent to the convertible security. The convertible security contains a contractual right to the conversion security, but the securities of the non-survivor contain no such right until the merger agreement has been approved. It is this "contractual right" upon which some courts have focused in order to justify the automatic imposition of liability.[41] In the merger area, however, as indicated by the *Newmark v. RKO General, Inc.* case, it is before this right comes into existence that the greatest possibility of abuse is present. Futhermore, even if the automatic imposition of liability theory were brought into the merger area without the requirement that there be a contractual right to the underlying security, because such an imposition of liability is limited to situations when there has been both a purchase and a sale of the underlying security within six months, the insider could speculate with impunity prior to the merger so long as he did not have any opposite transactions in the survivor's securities for the six months subsequent to the merger. Viewed in this light, it is apparent that *Blau v. Lamb's* underlying security rationale should be applied only to a simple, single conversion transaction. A more flexible rule is required when the transaction involves a complicated merger exchange. It must be recognized that "a merger or consolidation, perhaps more than any other transaction, involves many opportunities for abuse of confidential information,"[42] and that almost invariably, the merger exchange itself will have present the possibility of abuse which requires consideration of the imposition of liability. At the same time, such a rule would reintroduce the reasonable limitation of *Ferraiolo* to merger situations and would not require the imposition of liability upon transactions involving the purchase and sale of distinct securities of different issuers without regard to the possibility of any abuse in such situations.[43]

Further support for the adoption of the "possibility of abuse" test is provided by the fact that in a merger situation, the insider most

41. *See, e.g.*, Park & Tilford, Inc. v. Schulte, 160 F.2d 984 (2d Cir. 1947); Blau v. Hodgkinson, 100 F. Supp. 361 (S.D.N.Y. 1951).

42. Cook & Feldman, *supra* note 24, at 626.

43. *See* text accompanying note 35 *supra*. *See also* the discussion of Reg. 16b-9 and particularly example (5) in text accompanying notes 26-27 *supra*. This result insulates at least mergers and reclassifications from the "purposeless harshness" to which some conversion situations are now subject.

often will not be an insider of both the survivor and the non-survivor. Of course, the section 16(b) case law does not require that the insider be such at the time of both the prior purchase and the subsequent sale. A director has been held liable, even though he became an insider-director after he purchased the issuer's stock, on the theory that section 16(b) is aimed at all "changes of ownership" by the insider and does not require that he be such at the time of both purchase and sale.[44] The reason it is possible to hold a defendant liable, however, is because "a purchaser of stock need not have access to inside information in entering into his initial transaction;" it is the subsequent speculation after the defendant becomes an insider which is the " 'vice within the purview of section 16(b)' ".[45] For the part of the short-swing wherein he is an insider, he is speculating in the securities of the corporation in which he holds a fiduciary position.[46]

An insider has also been held liable for profits resulting from sales of his issuer's securities after his association with the issuer had ceased.[47] The insider's liability in this case, however, was expressly limited to the profits resulting from sales of securities that were purchased when he was associated with the issuer and sold shortly after the relationship ceased. The court's theory was that both the purchase and the sale could have been unfairly motivated by the insider's special knowledge of the issuer.

So viewed, these propositions add nothing which would support the matching-across theory and, in fact, support the "abuse of insider position" rationale found in *Ferraiolo.* Where an insider of the non-survivor only conducts pre-merger transactions in his issuer's securities, he is speculating in those securities. Post-merger transactions in the securities of the survivor are irrelevant vis-a-vis his former position as an insider with special knowledge of the affairs of the non-survivor. Similarly, where an insider of the survivor only conducts pre-merger transactions in the non-survivor's securities, he is speculating in securities of a corporation wherein he is not a section 16(b) insider.[48]

---

44. Adler v. Klawans, 267 F.2d 840 (2d Cir. 1959). *See also* Blau v. Allen, 163 F. Supp. 702 (S.D.N.Y. 1958); Stella v. Graham-Paige Motors Corp., 232 F.2d 299 (2d Cir. 1956), *cert. denied*, 353 U.S. 831 (1956); Marquette Cement Mfg. Co. v. Andreas, 239 F. Supp. 962 (S.D.N.Y. 1965) (defendant was an insider of survivor and non-survivor).

45. Blau v. Allen, 163 F. Supp. 702, 704 (S.D.N.Y 1958).

46. *Accord*, Lee National Corp. v. Segur, 281 F. Supp. 851 (E.D. Pa. 1968) (the court held that an officer of a subsidiary of the issuer is not an insider within the purview of § 16(b)).

47. Feder v. Martin Marietta Corp., 406 F.2d 260 (2d Cir. 1969).

48. Whether the atmosphere is a "disclosed" or an "undisclosed" one is irrelevant here

It should be recognized that limiting section 16(b) to transactions in securities of an issuer in which the defendant is an insider does not mean that recapture will be impossible against the insider of the survivor who engages in pre-merger transactions in the shares of the non-survivor. Section 16(b) is not a panacea for all insider abuse; the insider must also reckon with section 10(b).[49] While there is no reported decision precisely in point, the SEC has attempted to obtain restitution from insiders to shareholders who sold their stock to the insiders immediately before a merger.[50] In *SEC v. Texas Gulf Sulphur*,[51] the district court rejected the defendants' argument that section 16(b) limits the liability of directors and insiders to the terms of that provision. To the contrary,

> trading by an insider on the basis of material undisclosed information constitutes a deceptive practice in violation of the statute [Section 10(b)] and rule [Rule 10b-5].[52]

Although these statements were made with reference to insider purchases, they should be applicable in the same manner to insider sales. While under rule 10b-5, as opposed to section 16(b), the additional showing of an intent to use undisclosed inside information to speculative advantage is required,[53] this would afford slight consolation to the insider who trades before the announcement of the merger.

IV. CONCLUSION

The suggestion that it is possible to match across a merger has no foundation in any authority—either case law or SEC regulation—and there is no analogous authority suggesting that "matching across" will soon become a part of the law.[54] At the same time it must be recognized

---

since the possibility of abuse is not foreclosed in either case. *See* Marquette Cement Mfg. Co. v. Andreas, 239 F. Supp. 962 (S.D.N.Y. 1965).

49. See Jennings, *Insider Trading in Corporate Securities: A Survey of Hazards and Disclosure Obligations Under Rule 10b-5*, 62 NW. U.L. REV. 809 (1968), as a current example of the consideration of the ramifications of section 10(b) for their applicability to the merger situation.

50. SEC v. Golconda Mining Co., 246 F. Supp. 54 (S.D.N.Y. 1965).

51. 258 F. Supp. 262 (S.D.N.Y. 1966), *rev'd*, 401 F.2d 833 (2d Cir. 1968), *cert. denied* on appeals of defendants Coates and Kline, 394 U.S. 976 (1969) (Nos. 897 & 937).

52. 258 F. Supp. at 262.

53. In light of the recent opinion of the Second Circuit in the *Texas Gulf Sulphur* litigation, it is unclear whether the "intent" requirement consists of anything more than lack of diligence, constructive fraud, or even mere negligent conduct. 401 F.2d at 855.

54. While SEC Reg. 16b-9 would provide the SEC with a ready-made framework within

that while the judicial trend has been away from strict objectivity in the imposition of liability, this trend most often will be of no value in the merger situation. Merger exchanges, perhaps more than any other transactions, are fraught with the possibility of insider abuse. *Ferraiolo* presents a liability theory designed for the task of assessing the meaningfulness of imposing liability in these situations, and once assessed, *Smolowe v. Delendo Corp.* provides a profit recovery formula capable of effectuating the statutory scheme in both single and multiple transaction situations.

---

which to draft a merger regulation which has a broader application than Reg. 16b-7, there is no assurance that the regulation would be accepted by the courts. Reg. 16b-9 is extremely arbitrary in certain situations and, in concept, is contrary to the "possibility of abuse" rationale developed by the courts. In this light, it is worth noting that other SEC regulations have been held invalid on the ground that the SEC had no authority to adopt them. Feder v. Martin Marietta Corp., 406 F.2d 260 (2d Cir. 1969); B. T. Babbitt, Inc. v. Lachner, 332 F.2d 255 (2d Cir. 1964); Greene v. Dietz, 247 F.2d 689 (2d Cir. 1957); Perlman v. Timberlake, 172 F Supp. 246 (S.D.N.Y. 1959).