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SECURITIES REGULATION – THE STATUS OF THE EXEMPTIVE PROVISION OF SECTION 16(b) OF THE SECURITIES EXCHANGE ACT

*Foremost-McKesson, Inc. v. Provident Securities Co.*¹

Provident Securities Company was a personal holding company. In 1968 Provident tentatively decided to liquidate and dissolve, and employed an agent to secure a purchaser for its assets. Foremost-McKesson came forth as a potential buyer, but there was considerable disagreement as to the form of the consideration for the purchase. Provident had originally wished to sell for cash in order to facilitate distribution to its shareholders. Foremost wished to pay with its own securities. Negotiations eventually resulted in a compromise sale involving both cash and Foremost's convertible debentures.²

The final purchase agreement, executed on September 25, 1969, provided that Foremost would buy two-thirds of Provident's assets for \$4.25 million in cash and \$49.75 million in Foremost convertible subordinated debentures. Foremost was to register the debentures in the principal amount of \$25 million under the Securities Act of 1933, and participate in an underwriting agreement by which these debentures would be sold to the public. The closing date for this transaction was October 15, 1969. On that date, Foremost delivered the cash and a debenture in the principal amount of \$40 million to Provident. This debenture was subsequently exchanged for two debentures in the principal amounts of \$25 million and \$15 million. A \$2.5 million debenture was delivered to an escrow account on this same date. The balance of the purchase price, in the form of a \$7.25 million debenture, was delivered on October 20, 1969. These debentures were immediately convertible into more than ten percent of Foremost's outstanding common stock.

On October 21 Provident executed an underwriting agreement to sell the \$25 million debenture for \$25,366,666.66. The closing date of this transaction was to be October 28. Provident distributed \$22.25 million in debentures to its shareholders on October 24. Pursuant to the agreement, the underwriting transaction was closed on October 28, and as promptly as possible, Provident distributed the cash proceeds to its shareholders. Provident's corporate dissolution took place on August 31, 1970, after all liquidation proceedings had been completed.

Under section 16(a) of the Securities Exchange Act of 1934,³ one who is the beneficial owner of at least ten percent of a corporation's outstanding shares is considered an "insider" subject to section 16(b) liability. On October 20, 1969, Provident held a sufficient quantity of Foremost securities to be placed in this bracket. This status was terminated on October 24, 1969, when Provident distributed an amount of

1. 423 U.S. 232 (1976).

2. The factual material is reported at 423 U.S. at 235-37.

3. 15 U.S.C. § 78p (a) (1970).

debentures sufficient to bring its holdings below the ten percent level. In light of these transactions, Provident was faced with the possibility that Foremost would invoke section 16 (b)⁴ in an attempt to recover the profits Provident had realized from the sale of the Foremost debenture to the underwriters. Consequently, Provident brought an action for a declaratory judgment that it was not subject to section 16 (b) liability in connection with the above mentioned transactions.

While several alternative theories were pursued at the trial court level, Provident's ultimate liability turned on whether one who becomes a ten percent shareholder by virtue of his initial purchase is to be considered a statutory "insider." Specifically, the outcome depended on the Supreme Court's interpretation of the phrase "at the time of purchase and sale" in the exemptive provision.⁵

The United States Court of Appeals for the Ninth Circuit found that Provident was not liable because the language of the exemptive provision required one to hold ten percent "prior to" the purchase and sale sequence.⁶ The Supreme Court affirmed this "before the purchase" approach⁷ and held that Provident's corporate transactions with Foremost had not subjected the former to section 16 (b) liability.

The general purpose of 16 (b) is made quite clear in the section's first paragraph.⁸ Congress sought to discourage "insiders" from attempting to take advantage of the less well-informed investing public.⁹ It hoped to accomplish this by simply eliminating the short-swing profits realized by those who had access to inside information by virtue of their relationship with the issuer of the security involved.¹⁰

The existence of the proper "relationship" is an essential element in the rationale behind section 16 (b).¹¹ This is evidenced by the fact

4. Section 16 (b) of the Securities Exchange Act of 1934, 15 U.S.C. 78p (b) (1970), reads in part:

For the purpose of preventing the unfair use of information which may have been obtained by such beneficial owner, director, or officer by reason of his relationship to the issuer, any profit realized by him from any purchase and sale, or any sale and purchase, of any equity security of such issuer (other than an exempted security) within any period of less than six months . . . 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 This subsection shall not be construed to cover any transaction where such beneficial owner was not such both at the time of the purchase and sale, or the sale and purchase, of the security involved. . . .

5. 423 U.S. at 235.

6. *Provident Securities Co. v. Foremost-McKesson, Inc.*, 506 F.2d 601, 614 (9th Cir. 1974) noted at 12 HOUSTON L. REV. 768-71 (1975).

7. 423 U.S. at 235.

8. See note 4 *supra*.

9. 423 U.S. at 243, *Lewis v. Mellon Bank*, 376 F.Supp. 106 (W.D. Pa. 1974), *aff'd* 513 F.2d 921 (3d Cir. 1975).

10. 423 U.S. at 243-44, *Reliance Electric Co. v. Emerson Electric Co.*, 404 U.S. 418, 422 (1972).

11. 423 U.S. at 253-54, 506 F.2d at 608-614; S. REP. NO. 792, 73d Cong. 2d Sess. 9 (1934).

that while all directors and officers are restricted in their short-swing transactions, only those stockholders holding a sufficient percentage of the issuer's stock to support the presumption that they have access to inside information are covered by section 16 (b).¹² This distinction between officers, directors, and large shareholders is further accentuated in the exemptive provision. By the exemptive provision's express terms, stockholders who do not hold ten percent "at the time of" a transaction are not to be subjected to 16 (b) liability. Officers and directors are not mentioned in or affected by the exemptive provision. In other words, they are subject to 16 (b) liability regardless of the amount of stock they hold at the time of the transaction.¹³

Those persons lacking a required statutory "relationship" are not subject to liability under section 16 (b). For example, in *Kern County Land Co. v. Occidental Petroleum Corp.*¹⁴ the court suggested that a tender offeror's calculations that he may be able to resell the stock at a profit to a partner in a defensive merger "do not represent the kind of speculative abuse at which the statute is aimed, for they could not have been based on inside information obtained from substantial stock holdings that did not yet exist."¹⁵ It naturally follows that individuals not connected with the corporation in any way are entirely excluded from the provisions of section 16 (b).¹⁶

Although Congress did not intend to establish liability without fault,¹⁷ it did realize that if individual intent had to be proven in each case, section 16 (b) could not be enforced effectively.¹⁸ Therefore, it provided for absolute liability ". . . within . . . narrowly drawn limits."¹⁹ One's membership in the suspect class replaces intent if the other statutory requirements are fulfilled. First, beneficial owners, directors, and officers who hold for the proper period of time are presumed to have access to inside information.²⁰ This presumption is not conclusive and may be

12. See note 4 *supra*. It is for this reason that the requirement in the original bill that one hold 5% was raised in later versions to 10%. 506 F.2d at 611-612; *Hearings on S. Res. 84, S. Res. 56 and S. Res. 97, Before The Senate Committee on Banking and Currency*, 73d Cong., 1st Sess., pt. 15, at 6556, 7741-7743 (1934) [hereinafter referred to as 1934 Senate Hearings].

13. *Hearings on H.R. 7852 and H.R. 8720, Before the House Committee on Interstate and Foreign Commerce*, 73d Cong., 2d Sess., at 133 (1934) [hereinafter referred to as 1934 House Hearings].

14. 411 U.S. 582 (1973).

15. *Id.* at 597.

16. Congress apparently intended to exclude outsiders. Outsiders were originally covered where they had gotten information from insiders, but this coverage was deleted. It follows that since the insider provision was retained, outsiders were to be excluded. 506 F.2d at 614, 1934 Senate Hearings at 6560-6561.

17. 423 U.S. at 244.

18. 1934 Senate Hearings at 6557.

19. 423 U.S. at 251; *Hearings on Stock Exchange Practices Before the Senate Committee on Banking and Currency*, 73d Cong., 2d Sess., at 6556-6557 (1934).

20. *Reliance Electric Co. v. Emerson Electric Co.*, 404 U.S. 418, 423 (1972); 1934 Senate Hearings at 6557.

rebutted by proving such access was unobtainable.²¹ However, if one actually has access to inside information, any purchase and sale or sale and purchase sequence conducted within a six month period is conclusively presumed to be speculative.²²

If one does not fall within these narrowly defined limits, he is not subject to section 16 (b) liability. For instance, even a statutory insider may legally conduct purchase and sale transactions if such transactions do not occur within six months of each other.²³ In fact, one can conduct a short-swing transaction based entirely on inside information and still not be liable under section 16 (b) so long as the inside information is not obtained by virtue of his relationship to the issuer.²⁴ Loyalty to the principles behind section 16 (b) does not require all doubts to be resolved in favor of liability.²⁵

In spite of the readily accepted general purpose of section 16 (b), the proper construction of the exemptive provision has been the source of debate since the bill's inception.²⁶ Specifically, what requirement was the "at the time of" language intended to advance? Neither the commentators nor the circuits have been able to agree.²⁷ To some degree, this discord has been perpetuated by a failure to examine properly the legislative history in conjunction with the general purpose of section 16 (b).²⁸

Two major postulates concerning the proper construction of the exemptive provision have been expressed. The first concludes that "at the time of" was intended to mean "immediately after the purchase," or as it is alternatively stated, "simultaneously with the purchase." Under this view, the purchase which initially increases a buyer's holdings above ten percent is considered a section 16 (b) transaction and any profits realized from the sale of that security within six months are subject to recovery by the issuer.²⁹

The alternative position maintains that the exemptive provision requires one to hold ten percent "before the purchase." Under this approach, the purchase which originally sends one above the ten percent

21. *Kern County Land Co. v. Occidental Petroleum Corp.*, 411 U.S. 582, 598 (1973).

22. *Reliance Electric Co. v. Emerson Electric Co.*, 404 U.S. 418, 438 (1972). One is liable even if he actually has no information, *Gratz v. Claughton*, 187 F.2d 46 (2d Cir. 1951), *cert. denied* 341 U.S. 920 (1951); 1934 Senate Hearings at 6557.

23. 423 U.S. at 252.

24. *American Standard, Inc. v. Crane Co.*, 510 F.2d 1043, (2d Cir. 1974), *cert. denied* 95 S.Ct. 2397 (1975); *Kern County Land Co. v. Occidental Petroleum Corp.* 411 U.S. 582 (1973). Of course section 10 (b), 15 U.S.C. § 78j (b) (1970), as implemented by Rule 10 (b)-5, 17 C.F.R. 240.10b-5 provides a separate remedy in the case of actual abuse of inside information. *See* 423 U.S. at 255, n.29.

25. 423 U.S. at 252.

26. *Id.* at 239.

27. *Id.* at 240, nn.10 & 11, *see* 96 U.S. at 514, nn.10 & 11.

28. 423 U.S. at 242.

29. *See* text accompanying notes 31-36, 39 *infra*.

level is not a section 16 (b) transaction. Only purchases made by those with previous holdings amounting to ten percent or more are subject to a forced six month holding period.³⁰

The first case dealing with this issue to reach the court of appeals was *Stella v. Graham-Paige Motors Corp.*³¹ The trial court in *Stella* found that one came under the reach of section 16 (b) "simultaneously with" the purchase which made him a ten percent holder.³² Much of the impetus for choosing the broader interpretation came from the court's fear of what could happen in a sale and repurchase transaction if the "prior to" construction was followed. The court surmised that a large owner of stock could reduce holdings below ten percent and then repurchase without liability.³³ The second circuit approved this construction without comment,³⁴ other than a dissenting opinion which expressed the view that this construction went against the rationale behind the Act. The dissent concluded that one who acquires ten percent for the first time could not be a statutory insider for purposes of that acquisition. At the time of the decision to purchase, it could not yet be presumed that he had access to inside information.³⁵ This dissent made little apparent impact for the second circuit continued to follow the *Stella* reasoning in *Newmark v. RKO General, Inc.*³⁶ and *Perine v. William Norton & Co.*³⁷

The eighth circuit, which had originally adopted the "prior to" approach in *Arkansas Louisiana Gas Co. v. W. R. Stephens Investment Co.*,³⁸ later converted to the "immediately after the purchase" construction in *Reliance Electric Co. v. Emerson Electric Co.*³⁹

Of the cases mentioned, only *Reliance* and *Kern County* came before the Supreme Court, but in neither was the construction of "at the time of" considered.⁴⁰ The decision in *Provident Securities* was therefore essentially one of first impression. Being dissatisfied with previous constructions, the Court relied upon section 16 (b)'s legislative history as the primary authority in reaching its decision.

The Court examined the evolution of the bills which eventually became section 16 (b). The original bill read:

30. See text accompanying note 38 *infra* and 1 *supra*.

31. 104 F. Supp. 957 (S.D.N.Y. 1952), *rev'd on other grounds*, 232 F.2d 299 (2d Cir. 1956), *cert. denied*, 352 U.S. 831 (1956).

32. *Id.* at 960.

33. *Id.* at 959. This case was decided before section 10 (b) of the Securities Exchange Act was fully developed as a remedy for transactions involving the actual abuse of inside information. 423 U.S. 241, n.12.

34. 232 F.2d at 300-1 (2d Cir. 1956), *cert. denied* 352 U.S. 831 (1956).

35. *Id.* at 304-5.

36. 425 F.2d 348, 355-56 (2d Cir. 1970), *cert. denied*, 400 U.S. 854 (1970).

37. 509 F.2d 114, 118 (2d Cir. 1974).

38. 141 F. Supp. 841, 847 (W.D. Ark. 1956).

39. 434 F.2d 918 (8th Cir. 1970), *aff'd*, 404 U.S. 418 (1972).

40. 423 U.S. at 242, n.14, 411 U.S. at 584. In *Reliance* the Supreme Court dealt with the construction of "at the time of . . . sale" rather than "at the time of purchase." In any event, the holding in *Reliance* became "superfluous" after the Court's holding in the present case, 423 U.S. at 250, n.12.

It shall be unlawful for any director, officer, or owner of securities, owning as of record and/or beneficially more than 5 per centum of any class of stock of any issuer, any security of which is registered on a national securities exchange—

(1) To purchase any such registered security with the intention or expectation of selling the same security within six months; and any profit made by such person on any transaction in such a registered security extending over a period of less than six months shall inure to and be recoverable by the issuer, irrespective of any intention or expectation on his part in entering into such transaction of holding the security purchased for a period exceeding six months.⁴¹

The parties in *Provident Securities* agreed that this version necessitated that one hold the required percentage before a particular purchase in order for that purchase to be covered by section 16 (b).⁴² The major point of dispute was whether subsequent changes in the section's text had deleted this requirement.⁴³

The legislative history reveals that the most severe criticism of the original bill centered on its failure to provide for liability in a sale-repurchase sequence.⁴⁴ Subsequent versions remedied this deficiency by simply including such a provision. Also, the language which based liability for short-swing profits on ownership ". . . as of record and/or beneficially . . ." was found to be unsatisfactorily vague.⁴⁵ This was corrected by defining ownership to include anyone who either directly or indirectly is the beneficial owner of the required percentage of a registered security.⁴⁶ Neither of these changes was found to have altered the disputed requirement.⁴⁷

The most persuasive argument to the effect that the holding requirement was changed rests in the fact that later revisions in section 16 (b) did not retain the unambiguous language of the original bill which required ownership "before the purchase." However, the Court refused to assume that the requirement had been so lightly dropped, especially in light of the fact that the original drafters were "emphatic" about the provision.⁴⁸ Furthermore, the requirement met with no objections when considered during congressional hearings. The drafters "focused directly" on this provision during the hearings, but offered no criticism to the effect that it should be removed.⁴⁹

The Court concluded ". . . that the exemptive provision was intended

41. S.2693, 73d Cong., 2d Sess. (1934).

42. 423 U.S. at 247.

43. *Id.*

44. *Id.*; 1934 Senate Hearings, pt. 15; 1934 House Hearings at 1-623.

45. 423 U.S. at 247, *Hearings on Stock Exchange Practices Before the Senate Committee on Banking and Currency*, 73d Cong., 2d Sess., at 6914 (1934) [hereinafter referred to as *Hearings on Stock Exchange Practices*].

46. See notes 3 & 4 *supra*.

47. 423 U.S. at 248-50.

48. *Id.*

49. *Id.*; 1934 House Hearings at 133; *Hearings on Stock Exchange Practices*

to preserve the requirement of beneficial ownership before the purchase."⁵⁰ The Court found nothing in this section's subsequent history or other sections of the Securities Exchange Act which was inconsistent with this conclusion.⁵¹ The Court went on to say that even if the legislative history had been less clear, it would be hesitant to apply the strict liability of 16 (b) on the basis of ambiguous language. If such liability is to be imposed, it should be by a clearly expressed mandate of Congress to that effect.⁵² Consequently, one who conducts a purchase-sale transaction is subject to 16 (b) liability ". . . only if he was a 10% beneficial owner 'before the purchase.'"⁵³

The Court also mentioned, but expressed no opinion on, the ninth circuit's theory that the "at the time of" language should be subject to a dual interpretation.⁵⁴ This interpretation would depend on whether one is dealing with a purchase-sale or a sale-repurchase sequence. The application of this theory to the first sequence would produce a result consistent with the holding in the present case. One would be required to hold ten percent of the outstanding stock "before the purchase." However, in the sale-repurchase situation, the ninth circuit suggested that the language be construed to mean "simultaneously with." This would supposedly be consistent with the purpose of the Act, yet prevent manipulation of its express terms where a large holder of stock reduced his holdings below ten percent and then repurchased without liability.⁵⁵

The ninth circuit's construction is based on the assumption that the "at the time of" clause applies equally to both ends of a sale-repurchase and purchase-sale sequence. Under such an approach, the provision reads "at the time of purchase" and "at the time of sale," thereby requiring one to hold ten percent at the time of both transactions. The Supreme Court alluded to this reading in *Reliance*.⁵⁶ If this construction were followed in a sale-repurchase sequence, the dual interpretation of the "at the time of" clause would clearly provide for greater 16 (b) coverage than if one were required to hold ten percent before he made his repurchase.

The "before the purchase" holding in *Provident Securities* should adequately cover either a purchase-sale or a sale-repurchase if the "at the time of" requirement is not applied to both ends of a sequence. Such a construction would be more consistent with the legislative history of the section. As noted above, one of the major criticisms of the original bill was its failure to include liability in a sale-repurchase transaction. For the addition of a sale-repurchase transaction to have any substantial effect on the coverage of section 16 (b), it must be viewed as one sequence rather than an ordered pair of transactions. If the purchase-sale and sale-repur-

50. 423 U.S. at 249.

51. *Id.* at 251-60.

52. *Id.* at 252.

53. *Id.* at 250.

54. *Id.* at 242, n.15; see also *id.* at 243, n.16.

55. See text accompanying note 44, *supra*.

chase are approached in this manner, one would be subject to section 16 (b) liability if he held ten percent before he began a sequence. Thus, one who presumptively had access to inside information upon which to base his decision would face section 16 (b) liability whether he conducted a purchase-sale or a sale-repurchase. In this manner, the language "at the time of" could be construed consistently while alleviating the use of various manipulative devices such as step transactions. On the other hand, if the transactions are viewed as two separate entities, such that one must be a ten percent holder both "at the time of the sale" and "at the time of the repurchase," the provision is completely emasculated. All a speculator need do is sell amounts sufficient to take him below ten percent before repurchasing. This does virtually nothing to discourage insider speculation. Even with the dual interpretation, one is only liable if his repurchase takes him above the ten percent level.

It seems likely that the drafters intended to author a provision which was internally consistent and served the purpose of the section to the fullest extent, rather than one which had little effect unless subjected to an unnatural dual construction. For this reason, purchase-sales and sale-repurchases should be considered transactional units, and one who holds the requisite amount of stock before commencing either sequence should be liable under section 16 (b) regardless of the amount he holds during or after the transaction. In the words of the Court in *Reliance*, "where alternative constructions of the terms of 16 (b) are possible, those terms are to be given the construction that best serves the congressional purpose of curbing short-swing speculation by corporate insiders."⁵⁷

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57. 404 U.S. at 424.