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Securities Regulation - Application of Section 16(b) - Beneficial Ownership Liability for Short-Swing Profits. *Emerson Electric Co. v. Reliance Electric Co.*, 434 F.2d 918 (8th Cir. 1970)

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tion from these vehicles in the event of an accident, and any judicial precedent which holds that accidents, an extremely grim element of our daily existence, are not "intended uses" of automobiles is unwise and unrealistic. It is hoped that the *Badorek* decision, by virtue of its origin in the California courts, will serve as a ballast to the *Larsen* view and will mark a distinct turn against unreasonable refusals to extend the doctrine of strict liability in tort.

DANIEL J. PERRY

Securities Regulation—APPLICATION OF SECTION 16(b)—BENEFICIAL OWNERSHIP LIABILITY FOR SHORT-SWING PROFITS. *Emerson Electric Co. v. Reliance Electric Co.*, 434 F.2d 918 (8th Cir. 1970).

Emerson Electric Company, which owned no stock in the target corporation, acquired more than ten percent of Dodge Manufacturing Corporation's stock on June 16, 1967.¹ When its merger efforts failed, Emerson reduced its Dodge holding to less than ten percent. On September 11, 1967, after Dodge had merged with Reliance Electric Company, Emerson sold the remaining shares to Reliance.² Emerson instituted a declaratory judgment action to determine its liability under section 16(b) of the Securities Exchange Act of 1934³ for the profits realized from these two sales.

1. *Emerson Electric Co. v. Reliance Electric Co.*, 434 F.2d 918 (8th Cir. 1970). Emerson purchased 13.2 percent of Dodge's outstanding stock, a total of 152,282 shares, at \$63 per share. *Id.* at 920.

2. By the first sale Emerson reduced its holding to 9.96 percent. This sale of 37,000 shares was made on August 28, 1967, at \$68 per share. In the second sale which was completed on September 11, 1967, Reliance paid Emerson \$69 per share for the remaining 115,282 shares. *Id.* at 920.

3. Securities Exchange Act of 1934 § 16(b), 15 U.S.C. § 78p(b) (1964).

For the purpose of preventing the unfair use of information which may have been obtained by such beneficial owner, director, or officer by reason of his relationship to the issuer, any profit realized by him from any purchase and sale, or any sale and purchase, of any equity security of such issuer (other than an exempted security) within any period of less than six months, unless such security was acquired in good faith in connection with a debt previously contracted, shall inure to and be recoverable by the issuer, irrespective of any intention on the part of such beneficial owner, director, or officer in entering into such transaction of holding the security purchased or if not repurchasing the security sold for a period exceeding six months. Suit to recover such profit may be instituted at law or in equity in any court of competent jurisdiction by the issuer, or by the owner of any security of the issuer in the name and in behalf of the issuer if the issuer shall fail or refuse to bring such suit within sixty days after

The purpose of section 16(b) is to prevent a director, officer or a more than ten percent beneficial⁴ owner of an issuer of equity securities from unfairly using inside information which he may have obtained due to his position or substantial ownership of the issuer's securities.⁵ Short-swing profits⁶ realized by the more than ten percent beneficial owner may be recovered by the issuer without proof of actual use of inside information.⁷ The statute provides an exemption from section 16(b) liability for any transaction in which the beneficial owner was less than a ten percent owner "both at the time of the purchase and sale"⁸ Emerson contended that the profits in question were exempt from recovery since it was not a ten percent beneficial owner "prior to"⁹ the June acquisition.¹⁰ The trial court ruled that the phrase "at the time of purchase" includes the time "simultaneously with"¹¹ the purchase and therefore held that section 16(b) liability attaches to any purchase where a shareholder acquires a ten percent interest in the issuer.¹² The Eighth Circuit Court of Appeals affirmed.¹³

Although the subject of considerable conflicting scholarly discussion,¹⁴ the question of the proper interpretation of "both at the time

request or shall fail diligently to prosecute the same thereafter; but no such suit shall be brought more than two years after the date such profit was realized. This subsection shall not be construed to cover any transaction where such beneficial owner was not such both at the time of the purchase and sale, or the sale and purchase, of the security involved, or any transaction or transactions which the Commission by rules and regulations may exempt as not comprehended within the purpose of this subsection.

4. The more than ten percent level of ownership requirement is established by reading the phrase "such beneficial owner" of 16(b) in conjunction with subsection 16(a), which provides in pertinent part: "Every person who is directly or indirectly the beneficial owner of more than 10 percentum of any class of any equity security" Securities Exchange Act of 1934 § 16(a), 15 U.S.C. § 78p(a) (1964).

5. Securities Exchange Act of 1934 § 16(b), 15 U.S.C. § 78p(b) (1964)

6. Short-swing profits are made from the purchase and sale, or sale and purchase, of a stock within six months. W PAINTER, FEDERAL REGULATION OF INSIDER TRADING 24-25 (1968).

7. *Id.* The issuer's burden of proof is thus limited to a showing that defendant stockholder is the owner of more than 10 percent of issuer's stock.

8. Securities Exchange Act of 1934 § 16(b), 15 U.S.C. § 78p(b) (1964)

9. 434 F.2d at 922.

10. *Id.*

11. 306 F Supp. 588, 589 (E.D. Mo. 1969)

12. *Id.*

13. 434 F.2d at 924.

14. Text and law review authors who are in accord with the *Emerson* interpretation include: 2 L. LOSS, SECURITIES REGULATION 1060 (2d ed. 1961); Cook and Feldman, *Insider Trading Under the Securities Exchange Act*, 66 HARV. L. REV. 612, 631 (1953);

of purchase and sale" has been litigated only twice. The Second Circuit was first to consider the question in *Stella v. Graham-Paige Motor Corp.*¹⁵ The majority ruled that the ambiguous phrase was to be construed as meaning "simultaneously with,"¹⁶ agreeing with the lower court that any converse construction would defeat the legislative purpose of the enactment.¹⁷ A dissenting opinion contended that the statutory language was unambiguous and that Congress did not intend for the subsection to apply to a shareholder who though "a [10%] beneficial owner at the time of the sale was not such both at the time of the purchase and sale."¹⁸

The dissenting opinion in *Stella* was adopted by a district court in *Arkansas Louisiana Gas Co v. W R. Stephens Invest. Co*¹⁹ Thus, the federal courts which have considered the problem are split as to the proper resolution.

The *Emerson* court agreed with the majority view in *Stella* and therefore found Emerson Company liable as a more than ten percent shareholder at the time of sale within the meaning of section 16(b). The *Emerson* court then faced the novel issue²⁰ of whether the profits gained by the second sale, when Emerson owned less than ten percent of Dodge's stock, were recoverable by the issuer.²¹ The trial court had held that the profits from both sales were recoverable by the issuer. Although the two sales were separate transactions, the district court treated each

Seligman, *Problems under the Securities Exchange Act*, 21 VA. L. REV. 1, 19-20 (1934); 57 COLUM. L. REV. 287, 289 (1957).

15. 232 F.2d 299 (2d Cir. 1956), *cert. denied*, 352 U.S. 831 (1956).

16. 232 F.2d 299 (2d Cir. 1956), *aff'g* 104 F Supp. 957, 960 (S.D.N.Y. 1952).

17. Judge Kaufman argued that if the "prior to" interpretation of the exemption provision were adopted it would defeat the purpose of section 16(b) of preventing ten percent beneficial owners from using inside information.

It would be possible for a person to purchase a large block of stock, sell it out until his ownership was reduced to less than 10% and then repeat the process, *ad infinitum*. A construction such as this would provide a way for the evasion of 16(b) by principal stockholders, and render it largely ineffective.

104 F Supp. at 959.

The Second Circuit indicated its approval of this rationale. *But see* 9 STAN. L. REV. 582 (1957), wherein the student author persuasively argues that the persons Congress intended to hold liable were those who were 10 percent owners prior to the occurrence of the transaction in question.

18. 232 F.2d at 303, 305.

19. 141 F Supp. 841, 847 (W.D. Ark. 1956).

20. 434 F.2d at 925.

21. *Id.*

sale as part of "one continuous transaction"²² executed to avoid section 16(b) liability²³ On this point, the circuit court reversed and held that so long as the two sales were not "legally tied"²⁴ to each other they could not be treated as one sale regardless of the owner's intent.²⁵ The circuit court objectively²⁶ applied the provision of section 16(b) to the second sale and found its profits exempt from recovery²⁷

In the ultimate resolution of the proper construction of the exemption provision of section 16(b), the *Emerson* decision provides additional judicial weight to the interpretation established in the *Stella* case. Acceptance of this construction maintains the trend of liberally construing section 16(b)²⁸ and gives limited expansion to the types of transactions

22. The trial court described the sales as a "two step sales procedure" and "two sales effected pursuant to a single predetermined plan of disposition." 306 F Supp. at 592. The phrase "one continuous transaction" is suggested by the circuit court. 434 F.2d at 926.

23. The court based its conclusion upon a letter from Emerson's counsel which outlined ways of profitably disposing of the Reliance stock in the event that the merger failed.

The initial defensive step is for Emerson to reduce its holding of Dodge stock to less than 10%. From this point on, Emerson, no longer being a 10% stockowner of Dodge can sell the balance of its Dodge stock free of any 16(b) risk; provided of course, the second sale is not legally tied in any way to first sale.

306 F Supp. at 592. The district court also found it significant that negotiations with Reliance commenced the day after Emerson had made arrangements for the first sale. The court made it clear, however, that it did not suspect Emerson of a lack of good faith but it did question its right to avoid section 16(b) liability by a series of sales when in fact each was part of a plan to dispose of more than a 10 percent holding. *Id.* at 592-93.

24. The circuit court did not define what constituted "one continuous transaction," but held only that it would not classify as such two independent sales not legally tied to each other which were made to different buyers at different times. 434 F.2d at 926.

25. The decision did not fault the plaintiff corporation for attempting to avoid the loss of profits on its second sale of 115,282 shares and equated such conduct to legally permissible tax avoidance. *Id.* at 925.

26. One author has discerned a recent trend away from the "objective" method of applying the provisions of section 16(b). Under the traditional approach, the courts made no subjective determination of the use or likelihood of use of inside information and attached liability to all transactions by statutory insiders within a six month period. Lowensfeld, *Section 16(b): A New Trend in Regulating Insider Trading*, 54 CORNELL L. REV. 45 (1968). This author advocates that the subjective approach is the most practical means of avoiding imposition of loss of profits upon insiders who have not abused their privileged position. *Id.* at 64.

27. 434 F.2d at 926.

28. *E.g.*, *Ellerin v. Massachusetts Mutual Life Ins. Co.*, 270 F.2d 259, 263 (2d Cir. 1959); *Smolowe v. Delando Corp.*, 136 F.2d 231, 239 (2d Cir. 1943); *Molybdenum Corp. of America v. International Mining Corp.*, 32 F.R.D. 415, 419 (S.D.N.Y. 1963);

subject to its liability. The *Emerson* court, however, retreated from a possible greater expansion of section 16(b) by its rejection of the lower court's determination of the nature of the second sale.

The less stringent standard established by the *Emerson* court creates a judicial loophole by which the foresighted investor can intentionally and permissibly avoid considerable loss of profit.²⁹ The weakness of the *Emerson* case, as well as the inherent weakness of section 16(b),³⁰ is that it neither establishes a standard which promotes maximum effectual deterrence of the misuse of inside information nor permits a distinction between the culpable and nonculpable insider.³¹

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Feder v. Martin Marietta Corp., 406 F.2d 260, 262 (2d Cir. 1969); W. PAINTER, *supra* note 6, at 26.

29. By this ruling, so long as the transactions are not "legally tied," all profits, whether gained by inside information or not, on sales by one no longer owning more than 10 percent are not recoverable under section 16(b).

30. E.g., W PAINTER, *supra* note 6, at 25; Munter, *Section 16(b) of the Securities Exchange Act of 1934: An Alternative to "Burning Down the Barn in Order to Kill the Rats,"* 52 CORNELL L. REV. 69, 72-73 (1966). See also additional criticisms of the section made by L. Loss, *supra* note 14, at 1088; Munter, *supra*, at 72-77.

31. In Munter, *supra* note 30, at 100, the author suggests that the insider should "be allowed to exculpate with proof that he did not possess inside information."