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SHORT-SWING PROFITS IN FAILED TAKEOVER BIDS—THE ROLE OF SECTION 16(b)

Section 16(b) of the Securities Exchange Act of 19341 may create significant potential for liability when a takeover attempt fails.2 Defensive tactics by the target corporation may force the bidder to make a series of purchases, some coming after the bidder has attained 10% status.3 If the hostile takeover bid fails, the unsuccessful bidder often must dispose of the target's stock immediately, either because of financial pressures or because of the undesirability of being a minority shareholder in a hostile corporation. If the bidder sells the target's stock within six months of those purchases made after 10% status was reached, section 16(b) requires that the profit on the sale be relinquished to the issuer of the stock—in this case the victor of the takeover battle.

The goal of section 16(b) is to prevent the abuse of inside information by requiring insiders who trade in their corporation's stock to disgorge any short-swing profits. Takeover bids, however, usually do not involve the abuse of inside information. Although under the statutory definition takeover bidders4 become insiders when they acquire 10% of the target's stock,5 in practical terms they generally remain outside the target's control structure.

The result of section 16(b) is to discourage short-swing trading. When the insider is a takeover bidder, however, this result is inappropriate. Because the unsuccessful takeover bidder often sells large blocks of stock quickly,6 sometimes within six months of purchase, discouraging

1. 15 U.S.C. § 78p(b) (1982). Section 16(b) is designed to prevent the unfair use of inside information by corporate insiders trading in the stock of their own corporation. It provides that when an officer, director, or 10% shareholder makes a sale within six months of a purchase, or a purchase within six months of a sale, any profit on the transaction may be recovered by the corporation. Suit may be brought by the corporation or any shareholder.

2. See Ribstein, The Application of Section 16(b) of the Securities Exchange Act of 1934 to Tender Offers, 31 Sw. L.J. 503, 503 (1977); see also infra note 59 and accompanying text.

3. Under the exemptive provision of section 16(b), a 10% owner must be such "both at the time of the purchase and sale, or the sale and purchase, of the security involved." 15 U.S.C. § 78p(b) (1982). Purchases made after 10% status is attained are thus covered. See infra text accompanying notes 39-40.

4. The term "takeover bidder" refers to any party attempting to gain control of a corporation, whether through market purchases, private negotiations, or a tender offer. The term is used in this Comment rather than "tender offeror" because tender offers may be made for investment purposes rather than to gain control and because a takeover attempt may be made by means other than a tender offer. Whether the party in question is attempting to gain control must be gathered from the surrounding circumstances. See infra note 66.

5. The statutory definition of insiders includes officers, directors, and 10% shareholders.

6. See text accompanying notes 54-55.
short-swing sales of stock by an unsuccessful takeover bidder is tantamount to discouraging takeover bids.

Takeover bids should not be discouraged in this way. Corporate acquisitions have become a popular way for corporations to increase efficiency and market power and to realize tax benefits.\(^7\) The hostile takeover bid is a means for corporations to achieve the benefits of mergers where the management of the target corporation is opposed to a merger.

Although commentators generally view takeover bids as economically beneficial,\(^8\) Congress occasionally manifests its distrust of them in proposals for regulatory legislation.\(^9\) This distrust arises from the perceived threat of monopolistic combinations, an awareness that takeovers may be engineered to avoid tax liability, and the negative publicity that attends hotly contested takeovers.\(^10\) Still, takeover bids are favored by commentators\(^11\) and courts,\(^12\) and both Congress\(^13\) and the Securities Exchange Commission\(^14\) are neutral toward takeover bidders.

Courts have not analyzed takeover bids as a separate category of section 16(b) cases.\(^15\) They have neither recognized the takeover bidder as a unique insider nor the takeover bid as a unique transaction. This Comment examines the scope of section 16(b) liability for the unsuccessful takeover bidder. It then develops two possible analyses by which the

\(^{7}\) Weston & Chung, \textit{Do Mergers Make Money?}, MERGERS \& ACQUISITIONS 40, 40–42 (Fall 1983) (discussing several theories of why corporations merge in their research summary).

\(^{8}\) Takeover bids are generally considered good both for the economy and for the target’s shareholders. They serve as an incentive for corporate management to maintain efficiency, they enable corporations to combine assets and tax advantages, and they generally increase the market price of the target’s shares, thereby improving the shareholders’ position. \textit{See} Easterbrook & Fischel, \textit{The Proper Role of a Target’s Management in Responding to a Tender Offer}, 94 HArv L. REV 1161, 1165–74 (1981); Weston & Chung, \textit{supra} note 7.


\(^{10}\) \textit{Id}. This report particularly singles out the Bendix debacle as inspiring much of the recently proposed legislation.

\(^{11}\) \textit{See supra} note 8.


\(^{13}\) \textit{See infra} note 96 and accompanying text.

\(^{14}\) The SEC Advisory Committee on Tender Offers announced in a press release July 8, 1983, that “the Committee endorsed the premise upon which Federal regulation of takeovers has been based, which is that regulation should favor neither bidders nor targets.” 18 Mergers \& Acquisitions 20 (Summer 1983).

Section 16(b) and Takeover Bids

courts might exempt the takeover bidder from section 16(b)'s provisions. Alternatively, it recommends that if the courts do not exonerate takeover bidders, they should at least allow a less harsh calculation of profit.

I. THE SCOPE OF SECTION 16(b) LIABILITY IN THE TAKEOVER BID

Although section 16(b) was originally construed broadly, its application has been restricted by the so-called "pragmatic" approach and by a pro-defendant trend in Supreme Court decisions. To define the current scope of liability for the takeover bidder, it is first necessary to examine the background of section 16(b) and the recent Supreme Court decisions.

A. Background

The Securities Exchange Act of 1934\(^\text{16}\) was enacted in response to widespread abuses in securities transactions.\(^\text{17}\) At the time of its enactment, inside information was considered a perquisite for corporate insiders, who used the information to profit by short-swing trading.\(^\text{18}\) Section 16(b) of the Act was designed to prevent this abuse by requiring insiders to disgorge any profits thus realized.

The statute's drafters presumed that those covered by section 16(b)—officers, directors, and 10% shareholders—have access to inside information.\(^\text{19}\) Under the statute, the existence of a purchase and sale or sale and purchase of stock in the same issuer, within six months, creates a conclusive presumption that the insider traded on inside information and intended to engage in short-swing speculation. Section 16(b) requires no proof that the insider in fact used inside information or intended to engage in the second transaction within six months.

By requiring all insiders who engage in short-swing trading to disgorge any profit, Congress intended to prevent the misuse of corporate information for personal gain.\(^\text{20}\) The statute's drafters felt that the only way to accomplish this goal was to use a strict rule.\(^\text{21}\) The six-month time limit

\(^{16}\) 15 U.S.C. § 78p(b) (1934).

\(^{17}\) 2 L. Loss, Securities Regulation 1165–67 (2d ed. 1961).

\(^{18}\) 10 SEC. ANN. REP. 50 (1944).

\(^{19}\) The preamble to section 16(b) reveals this presumption, stating its purpose as "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." 15 U.S.C. § 78p(b) (1982).

\(^{20}\) Id.

\(^{21}\) See Hearings on Stock Exchange Practices Before the Senate Committee on Banking and Currency on S. 84, 73d Cong., 2d Sess. 6557 (1934) [hereinafter cited as Hearings].
allowed insiders to engage in long term investment and created a definite limitation on liability.

The statute was intended to be remedial, and, therefore, courts initially interpreted it broadly, construing it against the insider in all close cases. For this reason the courts construed the statutory terms "purchase" and "sale" to cover all types of stock dispositions. Once the transactions were found to be within the terms of the statute, liability followed automatically, and courts did not inquire into whether the insider could possibly have traded unfairly on inside information. The statute was viewed as creating a strict rule for a class of cases in which probability of such abuse was intolerably great. This automatic application of the statute's sanctions came to be known as the "objective" approach.

While the drafters of section 16(b) clearly envisioned such a strict application of its remedies, courts and commentators began to view the objective approach as a draconian trap for the unwary. Cases arose in which the insider had clearly not violated the spirit of the statute, yet the transactions could be viewed as within the letter of the statute. These cases involved stock conversions and reclassifications, which arguably were not purchases or sales within the meaning of section 16(b). To determine whether the transactions should create liability, courts began to ask whether an opportunity for speculative abuse actually existed.

Courts used a pragmatic approach in these cases, focusing on the purpose of the statute as applied to the case under consideration. As long as no opportunity existed for the abuse Congress sought to prevent, courts reasoned that the statute should not apply. This pragmatic approach focused on the form of the particular transactions. If the transaction was not clearly a "purchase" or "sale," the courts looked to the case's particular facts.

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23. See, e.g., Bershad v. McDonough, 428 F.2d 693, 697-98 (7th Cir. 1970) (granting of an option held a sale); Heli-Coil Corp. v. Webster, 352 F.2d 156 (3d Cir. 1965) (conversion of debentures to common held a sale); Park & Tilford v. Schulte, 160 F.2d 984, 987 (2d Cir.) (granting of an option held a sale), cert. denied, 332 U.S. 761 (1947).
26. For a general discussion of the development of the objective approach, see 2 L. Loss, supra note 17 at 1040-44.
27. See Hearings, supra note 21, at 6557; see also Smolowe v. Delendo Corp., 136 F.2d 231, 236 (2d Cir.), cert. denied, 320 U.S. 751 (1943); 2 L. Loss, supra note 15, at 1041.
29. See infra note 65.
30. See, e.g., Blau, 363 F.2d at 515; Roberts v. Eaton, 212 F.2d 82, 85 (1954).
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B. The Recent Supreme Court Approach to 10% Owners Under Section 16(b)

The Supreme Court disappointed proponents of the pragmatic approach with its 1972 decision in *Reliance Electric Co. v. Emerson Electric Co.*, in which it relied on the objective approach to limit the insider’s liability. The Court held that the exemptive provision of section 16(b) applied to the takeover bidder on the second sale in a two-step sales transaction when the first sale brought stock holdings to below 10%. The Court rejected the argument that liability for the second sale should be based on the fact that the stock was sold pursuant to an overall plan of disposal, pointing out that the two sales were not legally connected. The Court did not consider whether the second sale afforded the 10% owner an opportunity for speculative abuse, but instead literally applied the terms of the statute.

A year after *Reliance*, however, the Supreme Court applied the pragmatic approach in *Kern County Land Co. v. Occidental Petroleum, Inc.* The Court held that an exchange of stock pursuant to a merger agreement does not constitute a sale within the meaning of section 16(b). The Court began its analysis by stating that while “traditional cash-for-stock transactions” clearly fall within section 16(b), “unorthodox” transactions might not be included if no possibility existed for speculative abuse. The Court found that the stock exchange in *Kern* contained no possibility for speculative abuse because (1) the transaction was involuntary and (2) the defendant Occidental had no access to inside information.

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32. *See supra* note 3.
33. 404 U.S. at 421 (quoting from the Court of Appeals decision).
34. *Id.* at 425.
35. 411 U.S. 582 (1973). The *Kern* case arose as the result of an unsuccessful tender offer by the defendant Occidental for shares of Kern. Kern management negotiated a defensive merger with Tenneco, which Occidental was unable to block by court actions. The merger was approved with Occidental abstaining from voting its Kern shares. Prior to the vote, Occidental granted an option to purchase the Tenneco shares it would receive in the merger to a Tenneco subsidiary.
36. In its section 16(b) action, Tenneco argued alternatively that the granting of the option constituted a section 16(b) sale to be matched with Occidental's tender offer purchases. The court held that the option was not a sale at the time it was granted because Tenneco, not Occidental, determined whether it would be exercised. Tenneco could not exercise the option until six months and one day after Occidental's purchase; therefore, the court held that no sale occurred within six months of purchase.
37. 411 U.S. at 596.
38. *Id.* at 599. The court was unclear about the relationship of these factors to one another and to the speculative abuse finding. The lack of access to inside information was found to be critical as to the purchase, while involuntariness was the central factor as to the sale.
Finally, in *Foremost-McKesson v. Provident Securities, Inc.* the Supreme Court placed perhaps the most important limitation on the scope of section 16(b) liability for the takeover bidder. Relying again on section 16(b)'s exemptive clause, the court held that the purchase by which the purchaser becomes a 10% owner is not covered by section 16(b). By extension, purchases made prior to achieving 10% status also are not covered. The subsequent sale of stock within six months is therefore not matched with these purchases to create section 16(b) liability.  

C. The Current Scope of Liability for the Unsuccessful Takeover Bidder

1. The Effect of the Kern Analysis

Although the *Kern* decision did not state the threshold requirement for application of the pragmatic approach, subsequent courts have generally held that an involuntary transaction is necessary. To prove that a particular transaction is involuntary, the insider must apparently show that it had no control over the timing of the transaction. If the insider fails to

40. Id. at 250–51.
41. Commentators originally viewed *Kern* as requiring that a transaction be non-cash before the speculative abuse analysis applies. See, e.g., Lang & Katz, *Section 16(b) and "Extraordinary" Transactions: Corporate Reorganizations and Stock Options*, 49 Notre Dame L. Rev. 705, 725 (1974); Note, *Insider Liability for Short-Swing Profits: The Substance and Function of the Pragmatic Approach*, 72 Mich. L. Rev. 592, 623 (1974). The courts, however, have almost uniformly construed *Kern* as requiring that the transaction have been involuntary. For cases applying the involuntariness requirement in the takeover setting, see e.g., *Texas Int'l Airlines v. National Airlines, Inc.*, 714 F.2d 533 (5th Cir. 1983) (voluntary sale of stock by defeated takeover bidder creates liability), cert. denied, 104 S. Ct. 1326 (1984); *Allis-Chalmers Mfg. Co. v. Gulf & Western Indus., Inc.*, 527 F.2d 335 (7th Cir. 1975) (same), cross petitions for cert. denied, 423 U.S. 1078, 424 U.S. 928 (1976); *Lane Bryant v. Hatleigh Corp.*, 517 F. Supp. 1196 (S.D.N.Y. 1981) (same); *Tyco Laboratories, Inc. v. Cutler-Hammer, Inc.*, 490 F. Supp. 1 (S.D.N.Y. 1980) (same). For other types of section 16(b) cases in which courts have required involuntariness, see e.g., *Oliff v. Exchange Int'l Corp.*, 669 F.2d 1162 (7th Cir. 1980) (repurchase of stock under threat of IRS penalty is a voluntary purchase that creates liability), cert. denied, 450 U.S. 915 (1981); *Western Auto Supply Co. v. Gamble-Skogmo, Inc.*, 348 F.2d 736 (8th Cir. 1965) (sale pursuant to antitrust consent decree is voluntary and creates liability); *Sprague Elec. Co. v. Mostek Corp.*, 488 F. Supp. 842 (N.D. Tex. 1980) (sale required by right of first refusal is voluntary and creates liability); see also *Heublein, Inc. v. General Cinema Corp.*, 559 F. Supp. 692 (S.D.N.Y. 1983) (exchange of stock under merger agreement is involuntary and creates no liability), aff'd, 722 F.2d 29 (2d Cir.), cert. denied, 104 S. Ct. 1416 (1984).
42. Compare *Heublein, Inc. v. General Cinema Corp.*, 559 F. Supp. 692, 705 (S.D.N.Y. 1983), aff'd, 722 F.2d 29 (2d Cir.) (no liability attaches where defendant is unable to control timing of merger which requires it to dispose of stock within six months), cert. denied, 104 S. Ct. 1416 (1984) with *Oliff v. Exchange Int'l Corp.*, 669 F.2d 1162, 1166 (7th Cir. 1980) (liability attaches where it was within defendant's power to postpone stock sale beyond six-month limit), cert. denied, 450 U.S. 915 (1981).
make this showing, liability attaches automatically. If the insider does make this showing, however, courts will regard the transaction as unorthodox and will then ask whether the defendant had access to inside information. This inquiry, though secondary, is critical. One with access to inside information can speculate profitably by relying on an imminent "involuntary" transaction. A finding of involuntariness, therefore, does not guarantee exoneration.

In the context of the takeover bid, the Kern analysis may limit liability when the target engineers a defensive merger and the bidder receives shares of the merger partner in exchange for its shares of the target. Such an exchange is involuntary when the defeated bidder is unable to control the merger terms and is forced by the merger to "dispose" of the target's shares. Once the exchange is deemed involuntary, courts are likely to exonerate the bidder because its hostile posture usually guarantees it had no access to inside information.


44. See Heublein, 559 F. Supp. at 701.


46. Takeover bidders seeking to avoid liability have focused on whether a given sale transaction is subject to the Kern analysis. Bidders have also argued that purchases made pursuant to a takeover bid should be subject to the same analysis. The argument is that purchases in a takeover bid are "unorthodox" and should trigger the speculative abuse analysis. In rejecting this argument, courts have emphasized that whenever the trader controls the timing of the transaction there is a possibility for speculative abuse. See, e.g., Texas Int'l Airlines v. National Airlines, Inc., 714 F.2d 533, 540 (1983); Allis-Chalmers Mfg. Co. v. Gulf & Western Indus., Inc., 372 F. Supp. 570, 576 (N.D. Ill. 1974), aff'd, 527 F.2d 335 (7th Cir. 1975) cross petitions for cert. denied, 423 U.S. 1078, 424 U.S. 928 (1976).

47. See Heublein, Inc. v. General Cinema Corp., 559 F. Supp. 692 (S.D.N.Y. 1983), aff'd, 722 F.2d 29 (2d Cir.), cert. denied, 104 S. Ct. 1416 (1984). In Heublein the court exonerated the defeated takeover bidder, General Cinema. 559 F. Supp. at 702. Although General Cinema had made no formal tender offer, the court found other clear indicia of the target's hostility to General Cinema's bid. One indication was that General Cinema was the defendant in a section 13(d) action even before it acquired 10% status. Id. at 703. The court pointed out that General Cinema had no control over the timing of the transaction as it did not have control of the target's directors, or any influence on the target's management. Id.

The basis for the court's finding of lack of access is less clear. General Cinema had acquired information about the projected sales volume of Old Heublein's wine operation. Old Heublein had stipulated, however, in a Letter Agreement that certain information it was giving General Cinema was not "material information" under the securities laws. Without the stipulation, it is possible that the court would have found that General Cinema was liable. However, it may have been that the court relied primarily on Heublein's hostility to General Cinema's bid.

In affirming the district court's decision, the Second Circuit Court of Appeals announced that it rested its holding on the principle that an exchange of stock in a defensive merger was a class of transactions that, as a matter of law, did not give rise to section 16(b) liability. The court noted that
The potential shelter that the Kern analysis offers may provide little solace to the defeated takeover bidder, who is in the uncomfortable position of becoming a minority shareholder in the victorious corporation.\(^4\)

The more hotly contested the takeover battle, the more uncomfortable this position will be. While the defeated bidder may sell shares acquired in a defensive merger exchange within six months of its last purchase,\(^4\) the situation gives the victor leverage prior to the exchange agreement. In a case where the target defeats the bid without resort to a defensive merger, the takeover bidder must wait for six months to avoid liability.

Difficulties may also arise when there is a defensive cash merger by the target. Although no case has presented the problem,\(^5\) it is possible that the defeated bidder in a cash merger would face section 16(b) liability. In *Provident Securities, Inc. v. Foremost-McKesson*,\(^5\) the Ninth Circuit Court of Appeals found that the Kern analysis did not apply where a transaction is cash or cash-like.\(^5\) While the takeover bidder’s exchange of stock for cash in a defensive merger might be involuntary, it is not entirely clear that the transaction would be excluded from section 16(b) coverage.\(^5\)

Regardless of the defensive tactics of the target, the takeover bidder may face severe financial pressures if the bid fails. The bidder may have borrowed substantial sums to mount the takeover bid, planning to refinance at a lesser rate once the takeover is accomplished. The takeover bidder may wait until the merger closes and sell the shares it received in the merger exchange without facing section 16(b) liability.\(^5\) The delay, however, may result in higher interest costs than if the bid had been successful. If the target thwarts the bid without resort to a defensive merger, the protection afforded by the Kern analysis will not be present at all.


\(^{49}\) See infra note 54 and accompanying text.

\(^{50}\) *Texas International* would have presented such a case had the defendant not disposed of the critical shares prior to the closing of a cash merger agreement. The Foremost-McKesson rule foreclosed the issue of whether the remaining shares later exchanged in the cash merger created liability. 714 F.2d at 535-36.


\(^{52}\) *Id.* at 605.

\(^{53}\) *Id.*

\(^{54}\) Although the Supreme Court has not settled the question, the Second Circuit has held that the sale of stock received in a merger exchange is not to be matched with the purchase of stock of the merged corporation. *American Standard, Inc. v. Crane Co.*, 510 F.2d 1043, 1058 (2d Cir. 1974), *cert. denied*, 421 U.S. 1000 (1975).
Courts have rejected the argument, however, that an economically “forced” cash sale should be exempt from section 16(b) coverage.55

2. The Effect of Foremost-McKesson

The decision in Foremost-McKesson provides important protection to the takeover bidder by limiting liability to shares purchased after the bidder has reached 10% status, in transactions separate from the one by which 10% status is achieved.56 The protection, however, is not complete. If the takeover bid is by means of a tender offer, it is unclear when the bid triggers the Foremost-McKesson rule. Moreover, because a failed takeover bid may involve multiple purchases, the bidder may be exposed to significant liability despite the Foremost-McKesson rule.

When the bidder acquires shares pursuant to a tender offer, it is unclear whether the purchase occurs on tender, or at the time the offeror accepts the shares.57 If it is the time of tender, then the offeror faces potential liability on further shares tendered once tendered shares amount to 10%. If the offeror makes multiple tenders or accepts shares in separate transactions, liability may attach to later transactions though they are part of one tender offer plan.58

Even when transactions are protected by the Foremost-McKesson rule, the tender offeror may be exposed to significant liability.59 The offeror’s initial offer may net over 10% of the target’s stock and yet fall short of the amount necessary to gain control. In order to gain control, the offeror may have to extend its original offer, make another offer, or purchase on the market or through privately negotiated transactions. Any of these additional purchases may expose the offeror to section 16(b) liability if the takeover bid fails and a quick sale is precipitated.

A takeover bidder may also acquire stock through private or market purchases either entirely or prior to a tender offer. The bidder may wish to make these purchases in small bites to avoid inflating the stock price.

55. See supra note 41.
56. For example, in Texas International, the defendant purchased 121,000 shares of the target after it had reached 10% status. When it sold 790,000 shares within six months of that purchase, it was found liable for the profit only on the 121,000 shares purchased after reaching 10% status. Texas Int’l Airlines v. National Airlines, Inc., 714 F.2d 533, 535 (5th Cir. 1983), cert. denied, 104 S. Ct. 1326 (1984).
57. See Ribstein, supra note 2, at 512–16.
58. Id.
59. For example, in Texas International, the defeated takeover bidder was assessed over one million dollars, 714 F.2d at 536, and in Lane Bryant, the defendant was assessed $650,000 in wrongful profits on shares purchased after 10% status was reached. Lane Bryant v. Hatleigh Corp., 517 F. Supp. 1196, 1198 (S.D.N.Y. 1981).
Again, once the holdings exceed 10%, these purchases represent potential for liability under section 16(b).

Under *Foremost-McKesson*, then, the takeover bidder is protected only on those shares acquired up to the point at which 10% status is reached. Although a bidder may find it necessary to make further purchases after it reaches 10%, *Foremost-McKesson*’s mechanical rule provides no further protection. Moreover, because the time of purchase in a tender offer has not been established in section 16(b) cases, the line between insider and non-insider status is unclear. Thus, the takeover bidder may be required to litigate even though it may be ultimately exonerated.60

Together, the decisions in *Kern* and *Foremost-McKesson* limit liability for the takeover bidder, yet leave a significant area of exposure. Under current case law, the takeover bidder will be held liable on the voluntary sale of stock purchased after becoming a 10% owner. Even if the bidder exchanges shares of stock in a merger transaction, it may be liable if the court finds that it had control over the timing of the merger or access to inside information.61 Finally, a takeover bidder may be liable when it receives cash in a defensive merger.

II. POSSIBLE ANALYSES FOR EXONERATING THE TAKEOVER BIDDER

Despite the value of takeover bids and the inapplicability of section 16(b)’s purpose to takeovers, courts have refused to distinguish takeover bids from other types of section 16(b) transactions.62 The Supreme Court’s reasoning in *Kern* and *Foremost-McKesson* provide the basis of a possible analysis that distinguishes the takeover bid from the “garden variety” transaction, thus removing it from section 16(b) coverage.

60. While section 16(b) cases are often decided on motions to dismiss or motions for summary judgment, pursuing such motions and their appeal may be costly. Further, since the target is in an adversary relationship with the takeover bidder, it will be inclined to pursue a section 16(b) action. Even if it is not, section 16(b)’s provision for attorney fees makes it likely that some shareholder will pursue an action.

61. The pre-*Kern* decision in *Newmark v. RKO General, Inc.*, 425 F.2d 348 (2d Cir.), *cert. denied*, 400 U.S. 854 (1970), found the defendant liable on an exchange of stock pursuant to a merger agreement because of the defendant’s control over the timing and terms of the merger. That case, however, did not involve a hostile takeover attempt.

In a contest for control where the bidder is a hostile outsider, the merger is defensive, and the bidder as a stockholder opposes the merger, it is unlikely a court would impose liability. *See Heublein, Inc. v. General Cinema*, 722 F.2d 29, 31 (2d Cir.), *cert. denied* 104 S. Ct. 1416 (1984). It is unclear what the result would be if the takeover bid were hostile, but the bidder ultimately voted its shares in favor of a merger with another corporation.

62. *See supra* note 15 and accompanying text.
A. Application of the Kern Analysis Based on the Position of the Statutory Insider Rather than the Form of the Transaction

The pragmatic approach that has evolved from Kern focuses on the form of the transaction. The voluntary form of the transaction creates section 16(b) liability even though the statutory insider actually lacks access to inside information. This analysis results from a literal reading of the statute. Section 16(b) should not be literally applied, however, when such application would not further the statute’s purposes, for example when hostile takeover bidders have no access to inside information. An approach that is more consistent with the philosophy and goals of section 16(b) examines the position of the trader rather than the form of the transaction.

When the statute is considered in terms of the presumptions it creates, a compelling case can be made for an analysis based on the position of the insider. Section 16(b) creates two presumptions: (1) insiders have access to inside information, and (2) insiders engaged in short-swing trading intend to speculate, using inside information. If a transaction is involuntary, the takeover bidder may rebut the presumption of an intent to speculate. Once that presumption is rebutted, courts inquire further into the validity of the presumption of access to inside information. An insider is exonerated if it can show a lack of such access.

Courts should also allow the insider to prove that no improper speculation occurred when the presumption of access to inside information is rebutted, regardless of whether the transaction is voluntary. That presumption is rebutted when the insider is a member of a class of insiders who generally do not have such access because of their relationship to the issuer. In a hostile takeover attempt the takeover bidder is unlikely to have access to inside information. Hostile takeover bidders, as a class, 

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63. Cf. United Housing Foundation, Inc. v. Forman, 421 U.S. 837, 849 (1975) (instruments denominated “stock” not within Securities Acts’ definition of “security,” even though “security” was defined to include “stock”).

64. See Note, Exceptions to Liability Under Section 16(b): A Systematic Approach, 87 YALE L.J. 1430 (1978) (arguing that courts should exonerate noncontrolling 10% owners who can demonstrate lack of access to inside information).

65. In the conversion and reclassification cases that gave rise to the pragmatic approach, the courts exonerated the defendants because of the continuity of investment or because the two classes of stock were viewed as economic equivalents. Where these factors were present, the courts found there was no possibility for speculative abuse. See, e.g., Blau v. Lamb, 363 F.2d 507 (2d Cir. 1966), cert. denied, 385 U.S. 1002 (1967); Roberts v. Eaton, 212 F.2d 82 (1954). The SEC has since exempted conversions and reclassifications by Rule 16b-9. The only factor which appears to have continued vitality in triggering the pragmatic inquiry is the involuntariness of the transaction.

66. Whether the defendant is in the position of a hostile takeover bidder must be determined from the surrounding circumstances, including the bidder’s declaration of intent in a Schedule 13D statement. See also supra note 47. The Schedule 13D statement is required of all shareholders owning
should therefore have the opportunity to prove that they in fact had no access to inside information and so could not have improperly speculated in violation of the goal of section 16(b).\(^{67}\)

Once it is proved that the takeover bidder was hostile to the target and had no access to inside information, inquiry into the insider's intention is unnecessary.\(^{68}\) The only speculation section 16(b) seeks to curb is that based on inside information. Speculators may seek to manipulate the price of stock by making large purchases in a short period.\(^{68}\) That type of speculation, however, is based on market information and not inside information.\(^{69}\) Section 16(b) was clearly not designed to control abusive practices in this area.

The speculative abuse analysis suggested here carries out the intent of the statute as effectively as the existing approach, which relies on the form of the transaction. In both approaches the focus is on whether conduct prohibited by the statute has occurred, the application depends on whether a statutory presumption has been prima facie rebutted, and the inquiry is confined to a definable class—either transactions or insiders—that does not fall within the intent of the statute. If the reason for applying the statute does not exist in the case of takeover bidders, it should not be applied to them. In addition, the takeover bidder exchanging shares for stock within six months is arguably in the same position as the takeover bidder exchanging shares for cash.\(^{70}\) The two should therefore be treated similarly under the statute.

Moreover, this proposed analysis need not create unpredictable and

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\(^{67}\) If the defendant's position as a hostile takeover bidder rebuts the presumption, the burden of proof may shift to the plaintiff, or the defendant insider may be allowed to go forward with evidence to support its burden of proof. Because section 16(b) is a remedial statute to be given broad application, the burden of going forward with evidence and the burden of proof should be on the defendant. For an interesting proposal for abolishing the objective rule and changing section 16(b) to a statute which creates rebuttable presumptions, see 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.Q. 69 (1966).

\(^{68}\) The court in *Heublein* acknowledged that such price manipulation often occurs. 559 F. Supp. at 694. The court's discussion hinted that the defendant in *Heublein* was engaged in such market manipulation. Nevertheless, the court exonerated the defendant based on the reasoning in *Kern*.

\(^{69}\) *Kern*, 411 U.S. at 597–98.

\(^{70}\) It is not enough to say that those selling for cash within six months are in a substantially different position than those who have exchanged stock. First, the exchange of stock is a change in investment which may quantifiably change the insider's position; thus there is no "continuity of investment" as in the conversion cases. See supra note 65. Second, the insider apparently may sell the stock received in the exchange, still within six months, and not face liability. American Standard, Inc. v. Crane Co., 510 F.2d 1043, 1058 (2d Cir. 1974), *cert. denied*, 421 U.S. 1000 (1975). In that event it is in the same position as the insider who sold the original target stock within six months, i.e., it has cash in hand.
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inconsistent results if the class is specifically and narrowly defined. The class should be limited to takeover bidders in a hostile takeover attempt. Whether the takeover attempt was hostile is a question of fact to be determined from the surrounding circumstances. Because the concern here is with the failed takeover attempt, it will be likely that the attempt was hostile. Finally, takeover bids serve a valuable purpose in the economy. Target corporations should not be allowed to use section 16(b) as a defensive weapon.

B. Foremost-McKesson and the Unified Plan

In Foremost-McKesson the court held that the thrust of the exemptive provision is to require that both transactions giving rise to section 16(b) liability occur while the insider is a 10% owner. This reading forecloses any inquiry into the possibility for speculative abuse prior to the time at which the insider became a 10% owner. The holding of the case can thus be seen as contrary to the pragmatic approach. Still, its reasoning bolsters the argument that, under a speculative abuse analysis, the takeover bidder should be exempt from liability even on purchases made after 10% status has been achieved.

In Foremost-McKesson, the respondent argued that once the purchaser becomes a 10% holder, it presumptively has access to inside information and a subsequent sale within six months is presumptively based on that information. Liability should thus attach because at least one transaction presumably involved an improper use of inside information. The Court rejected that argument, pointing out that inside information must have been available to the insider at the time of purchase as well. The Court then observed that the crucial point in a purchase transaction is the point at which the decision is made to acquire the stock. The Court noted that

71. One difficulty with such an approach is that section 16(b) creates a mandatory objective rule. The drafters of section 16(b) created an objective rule because they felt that it was too difficult to prove that the insider intended to make a profit on the short swing. See Hearings, supra note 21, at 6557 (Corcoran, T., testifying). Although legislative history is not as clear on the question of access to inside information, that too was presumably seen as too difficult to prove. An objective statute removed this burden of proof from the plaintiff and placed responsibility on the insider to structure transactions in a way that avoids liability. As with the existing pragmatic approach, however, the same rationale should apply—if the statute's purpose is not served, a strict rule should not be followed.

72. See supra note 66.
73. See supra note 8.
74. See Heublein, 559 F. Supp. at 701 n.16.
76. Id. at 254 n.28.
when a large block of stock is acquired, that decision may precede the actual purchase by a considerable period. 77

Although the Court emphasized that the decision to make a single large purchase is usually made well in advance of the purchase, the same reasoning applies when the takeover bidder makes a decision to acquire control of the target. The decision to make the takeover bid is followed by a purchase, or a series of purchases, in an attempt to gain control. If the decision to acquire control is made before insider status is achieved, and a purchase or series of purchases is made pursuant to an overall plan of acquisition, an application of the Foremost-McKesson Court’s reasoning exempts the purchaser from section 16(b) liability. 78 When the takeover bidder can show that the purchases that created liability were made pursuant to a unified plan of purchase, formulated in advance of achieving 10% status, it should be exonerated. 79

The takeover bidder’s decision to acquire control well in advance of attaining 10% status, combined with the bidder’s lack of access to inside information, 80 supports the conclusion that takeover bidders should not be automatically liable under section 16(b). Exoneration of the takeover bidder is also supported by the Court’s recent pro-defendant decisions in both section 16(b) and 10(b) litigation. 81 The pro-defendant trend in section 16(b) cases 82 indicates the Supreme Court’s general tendency to relieve takeover bidders of section 16(b) liability. The Court has been unwilling to apply the literal terms of the statute in cases where its purpose is not served. This reluctance may presage the Court’s adoption of

77. Id.
78. In Reliance, the Court rejected the argument that two separate sales clearly made pursuant to a single plan of disposition should be considered as connected under section 16(b). 404 U.S. at 425. This need not undercut the analysis suggested here, that the separate purchases of a takeover bidder be considered as one under the Foremost-McKesson rule. First, exoneration of the takeover bidder is additionally supported by the likelihood that the bidder has no access to inside information, even after 10% status is acquired. Second, the holding of Reliance itself was rendered irrelevant by the holding in Foremost-McKesson: a two-step sale is no longer necessary to avoid liability, as the shareholder may sell all its shares at once and the Foremost-McKesson rule will protect the initial 10% from liability. Foremost-McKesson, 423 U.S. at 250 n.25. Finally, the Reliance decision can be viewed not as a statement for the strict objective approach but as one in a series of cases by which the Supreme Court has limited liability for takeover bidders and other defendants under section 16(b). See infra note 82 and accompanying text.
79. The step transaction doctrine in tax law is analogous here. Under that doctrine, formally separate transactions are treated as a single transaction “if they are in substance integrated, interdependent, and focused toward a particular end result.” B. Bittker & J. Eustice, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS 14-131, § 14.51 (abridged 4th ed. 1979).
80. See supra Part IIA.
82. See generally Lowenfels, supra note 81.
an analysis that will further protect the takeover bidder who has sold shares of the target for cash.83

III. THE MEASURE OF PROFIT IN A FAILED TAKEOVER ATTEMPT

Courts may continue to find the pragmatic analysis inappropriate when the takeover bidder makes a voluntary sale. If so, they should minimize the impact of section 16(b) on takeover bidders by adjusting the calculation of profit. Such an adjustment is justified by the difference between the takeover bidder and other 10% shareholders.

The measure of profit in ordinary section 16(b) cases was established in Smolowe v. Delendo Corp.,84 in which the court concluded that the goals of section 16(b) require that all possible profit be squeezed from the transaction.85 The court therefore based its calculation of profit on the lowest-in-highest-out formula (LIHO). It specifically rejected other methods as susceptible of manipulation by the insider to avoid liability.86 Courts have since continued to use the quasi-punitive LIHO formula to calculate profit,87 allowing deductions only for costs directly connected with the trading of the stock.88 This method of profit calculation can impose

83. The Supreme Court recently denied certiorari to a case directly presenting this issue. Texas Int'l Airlines v. National Airlines, Inc., cert. denied, 104 S. Ct. 1326 (1984). An alternative proposed for exonerating a category of takeover bidders is put forth by Ribstein, supra note 2. He suggests exempting from section 16(b) all purchases made pursuant to a tender offer, because the disclosure requirements that accompany a tender offer generally guarantee no abuse of inside information. Such a proposal, however, provides no protection where the takeover bidder engages in market or private transactions.

84. 136 F.2d 231 (2d Cir.), cert. denied, 320 U.S. 751 (1943).

85. Id. at 238.

86. The court pointed out that a calculation based on identity of stock certificates would allow an insider with older, cheaper stock to trade without liability. A calculation based on average price would allow the insider who had experienced a loss during the six-month period to subsequently trade at a profit, again without liability. Id. at 238–39.


88. Thus, courts will allow a deduction for brokerage commissions and transfer taxes. Oliff v. Exchange Int'l Corp., 669 F.2d 1162 (7th Cir. 1980). Whether dividends are added in a purchase-sale sequence, or subtracted in a sale-repurchase sequence, apparently depends on the circumstances of the case. See Allis-Chalmers Mfg. Co. v. Gulf & Western Indus., Inc., 372 F. Supp. 570 (N.D. Ill. 1974), rev'd on other grounds, 527 F.2d 335 (7th Cir. 1975), cross petitions for cert. denied, 423 U.S. 1078, 424 U.S. 928 (1976). The value of a control premium may also figure into the calculation. See, e.g., Mueller v. Karholz, 449 F.2d 82 (7th Cir. 1981) (addition to market price of 20% control premium decreases award); Newmark v. RKO General, Inc., 425 F.2d 348 (2d Cir.) (15% control premium added to increase award), cert. denied, 400 U.S. 854 (1970).

Courts generally reject claims of deductions for administrative expenses, interest on loans used to purchase the shares, office overhead, and litigation relating to an attempt to gain control. See, e.g., Texas Int'l Airlines v. National Airlines, Inc., 714 F.2d 533 (5th Cir. 1983), cert. denied, 104 S. Ct.
liability for short-swing profits even in cases where the insider suffered a loss. 89

Courts justify this harsh measure of damages by invoking 16(b)'s overriding goal of preventing any insider trading. The drafters of section 16(b) sought to prevent insider trading for two reasons. First, a statutory insider occupies the position of a fiduciary, 90 and fiduciaries are held to the strictest standard of conduct. 91 The insider's use of corporate information for personal gain is a breach of fiduciary duty to the corporation. 92 Second, one of the Securities Acts' broad goals was to create honest and fair markets. 93 Section 16(b) contributed to this goal by removing the profit incentive for those with advance information. It thereby protected the outsider trader from unfair competition by insiders. To carry out the statute's goal of prevention, then, the courts adopted a punitive measure of calculating profit.

Those evils do not necessarily exist, however, in the hostile takeover setting. Although the bidder may owe a fiduciary duty to other shareholders, it is not in a position to misappropriate corporate information for its own benefit. 94 The takeover bidder competes against the small investor not on the basis of inside information, but on the basis of market analysis, in which it has often invested heavily. 95 The takeover bidder cannot violate its duty to other shareholders or to the investing public by unfairly trading on inside information to which it has no access.

More importantly, the preventive goal of section 16(b) is inappropriate to the takeover bidder. In passing the Williams Act, 96 Congress made clear that takeover bids were to be controlled, but not discouraged. Courts have also indicated that takeover bids can be beneficial to stockholders. 97


94. See supra notes 46-50 and accompanying text.

95. See Easterbrook & Fischel, supra note 8, at 1178.

96. Securities Exchange Act of 1934 §§ 13(d)-(f), §§ 14(d)-(f); 15 U.S.C. §§ 78m(d)-(f). §§ 78n(d)-(f) (1982). In hearings prior to passage of the Act, Congress made clear that the legislation was intended to deal even-handedly with both bidders and targets. See Hearings before the Subcomm. on Securities of the Senate Comm. on Banking and Currency on S.510, 90th Cong., 1st Sess. 37 (1967).

97. See supra note 12.
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and the SEC has taken a position of neutrality in takeover contests.98 Courts currently calculate profits to arrive at punitive awards. They should adjust the calculation so that the unsuccessful takeover bidder is treated neutrally and neither gains by short-swing trading nor loses because of a punitive calculation of profits.

Application of this approach would have a two-fold effect on the calculation of profit in the takeover setting. First, the proper formula would be based on a traditional notion of profit, the average sale price less the average purchase price of stock traded within the six-month period. Second, a deduction would be allowed for costs reasonably connected with the takeover bid. These costs should include interest charges on funds used to purchase stock, the cost of mounting a tender offer, funds spent on a proxy contest for control, and reasonable attorney fees, including the cost of defending the section 16(b) action and other actions connected with the takeover attempt.99 For purposes of a deduction, these costs should be prorated based on the ratio of the number of shares on which liability is found to the total number of shares purchased in the takeover attempt.100

Calculating such costs may involve additional litigation; however, separate hearings or trials are already commonly held to determine the measure of profit in section 16(b) actions.101 Courts are equipped to deal with this type of calculation,102 and corporations are also accustomed to assessing the cost of a takeover attempt in reports to their shareholders.103 The importance of treating the takeover bidder neutrally outweighs any inconvenience created by such a calculation of profit.

The deductions suggested above would also result in the takeover bidder being treated more equally with other types of section 16(b) insiders. In the normal transaction, an officer, director, or 10% owner incurs only brokerage commission costs and transfer taxes. The allowance of a deduction for these costs reflects the actual cost to the insider of the purchases. In the case of a takeover bidder, the cost of acquiring a large block of stock includes the cost of mounting the takeover bid.

98. See supra note 14.
99. See supra note 88.
100. The prorating is necessary since it would be unfair not to include any profit on the first 10% purchased, and yet allow a deduction for the costs associated with acquisition of that 10%.
102. The courts have demonstrated a facility for dealing with the most complex questions of valuation and calculation in section 16(b) actions. See, e.g., Newmark v. RKO General, Inc., 425 F.2d 348 (2d Cir.), cert. denied, 400 U.S. 854 (1970).
IV. CONCLUSION

Courts should not impose section 16(b) penalties in the context of hostile takeover bids. The Supreme Court has taken a step in this direction by limiting the liability of takeover bidders when the language of the statute permits. Courts should go further, however, in limiting section 16(b) liability, because penalizing takeover bidders does not comport with the rationale or goals of section 16(b). The recent trend in section 16(b) jurisprudence may indicate that such a move is imminent. At the least, courts should mitigate the penal aspects of the statute’s operation by calculating the takeover bidder’s profits more realistically.

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