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# *Lewis v. McAdam*: A Narrow Interpretation of Standing Fulfills the Purpose of Section 16(b) of the Securities Exchange Act of 1934

## I. INTRODUCTION

Section 16(b) of the Securities Exchange Act of 1934 ("Section 16(b)")[1] was designed to curb insider trading leading to "sure thing"[2] profits at the expense of individual stockholders and "to protect the securities markets from untoward influences."[3] A series of cases over the years has explored various aspects of Section 16(b) such as: what is a purchase and sale;[4] who is an issuer;[5] who are beneficial owners;[6] and limits of the statute's purposes.[7] However, one aspect of Section 16(b) not fully elucidated by case law is the question of standing. In deciding who has standing when an issuer corporation is extinguished

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[1] Securities Exchange Act of 1934 § 16(b), 15 U.S.C. § 78p(b) (1982).

[2] Profits made by corporate insiders as a result of their access to inside information. "Sure thing" profits were considered to be a perk of office until the enactment of the Exchange Act in 1934. *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).

[3] Yourd, *Trading in Securities by Directors, Officers and Stockholders: Section 16 of the Securities Exchange Act*, 38 MICH. L. REV. 133, 144 (1939).

[4] Newmark v. RKO General, Inc., 425 F.2d 348 (2d Cir. 1970), *cert. denied*, 400 U.S. 854 (1970) (in determining whether a transaction is a purchase or a sale under Section 16(b), it is necessary to consider whether there is a potential for speculative abuse because of the purchaser's or seller's access to inside information).

[5] Portnoy v. Kawecki Berylco Indust., Inc., 607 F.2d 765 (7th Cir. 1979) (the issuer is the person who issues the security involved in the short-swing transaction).

[6] Rothenberg v. United Brands Co., Fed. Sec. L. Rep. (CCH) ¶ 96,045, at 91,690 (S.D.N.Y. 1977) (beneficial ownership of a security of an issuer may be lost as a result of a merger of the issuer and another corporation).

[7] *See, e.g.*, Kern County Land Co. v. Occidental Petroleum Corp., 411 U.S. 582 (1973) (the purpose of section 16(b) is to protect the public by preventing insiders from purchasing or selling stock on the basis of information that may have been obtained through the insider's relationship to the corporation); Reliance Elec. Co. v. Emerson Elec. Co., 404 U.S. 418 (1972) (Section 16(b) does not impose liability on an insider for profit realized on the sale of stock sold more than six months after purchase, although the sale was planned within six months of purchase); Blau v. Max Factor & Co., 342 F.2d 304 (9th Cir. 1965), *cert. denied*, 382 U.S. 892 (1965) (the abuses inherent in insider trading can best be controlled through a flat rule eliminating profits from a class of transactions in which the possibility of abuse is intolerably great); Smolowe v. Delendo Corp., 136 F.2d 231 (2d Cir. 1943), *cert. denied*, 320 U.S. 751 (1943) (Congress intended 15 U.S.C. § 78p(b) to prevent conflict between the fiduciary officer, director or stockholder's selfish interest and the performance of his duty by removing all profits from the transactions covered).

in a merger, *Lewis v. McAdam*,[8] a 1985 Ninth Circuit case, interpreted standing narrowly, limiting standing to the issuer or holders of securities of the issuer. This note examines how the *Lewis* decision, in contrast to *Blau v. Oppenheim*,[9] reached its result, and how that result fulfills the purpose of Section 16(b).

## II. BACKGROUND

### A. *Section 16(b) and Its Purposes*

The Securities Exchange Act of 1934 ("Exchange Act") was passed in response to stock market abuses during the Coolidge and Hoover administrations that led to the infamous Wall Street crash of 1929.[10] The Exchange Act was drafted by the House Interstate and Foreign Commerce Committee, which labored for nine weeks before submitting it for a house vote.[11] The bill underwent many changes in both the House and Senate before it was finally approved.[12] Section 16(b) specifically addresses the problem of corporate insiders who abuse

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[8] 762 F.2d 800 (9th Cir. 1985).

[9] 250 F. Supp. 881 (S.D.N.Y. 1966). In allowing a shareholder of a parent company standing to sue, the *Blau* court adopted a much broader interpretation of Section 16(b) than did the *Lewis* court. The Supreme Court has interpreted Section 16(b) in only three decisions: *Kern County Land Co.*, 411 U.S. at 591-96; *Reliance Elec. Co.*, 404 U.S. at 422-27; Blau v. Lehman, 368 U.S. 403, 409-11 (1962). Lower court cases are therefore quite significant in interpreting the statute.

[10] 78 CONG. REC. 10,995 (1934). The Exchange Act includes various other regulatory measures, some of which may come under particular scrutiny in light of the insider trading scandal that broke in the fall of 1986 involving Ivan Boesky, a Wall Street arbitrageur.

[11] *Id.*

[12] *Id.* Section 16(b) provides:

> 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, or 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 of 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 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.

15 U.S.C. § 78p(b).

their positions of trust to enrich themselves at shareholders' expense.[13] The framers of Section 16(b) sought to create a damage action that outsiders could bring against corporate traders who profited through inside information not available to the general investing public.[14] To "protect the interests of the public against the predatory operation of directors, officers, and principal stockholders of corporations by preventing them from speculating in the stock of corporations to which they owe a fiduciary duty,"[15] the issuer of securities or a holder of securities of the issuer may bring suit on transactions involving the abuse of inside information.[16] Actual abuse of inside information need not be proven.[17]

### B. *Putting Lewis and Blau in Context*

Early Section 16(b) cases were routinely decided under an "objective"[18] approach in which courts assumed that insiders had access to inside information and that they must have abused this information whenever there was a profitable short-swing[19] transaction.[20] As an antidote to this harsh approach, courts developed a "pragmatic"[21] way of interpreting Section 16(b) issues, particularly in response to modern types of corporate reclassifications and reorganizations not anticipated in 1934.[22] The pragmatic approach focuses on the policy behind the statute's terms.[23] One danger inherent in the pragmatic approach to Section 16(b) interpretation is to overlook the statute's literal command in the attempt to justify a particular policy reading.

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[13] Reliance Elec. Co., 404 U.S. at 602-03. Section 16(b) is not the only means of recovering profits improperly gained by outsiders. Section 10(b) (15 U.S.C. § 78 j(b) Securities Exchange Act of 1934) and SEC Rule 10b-5 promulgated thereunder (extending the common law concept of fraud to cover failure to disclose material information that might have affected a transaction) are anti-fraud provisions.

[14] Hearings of S. Res. 84, S. Res. 56 and S. Res. 97 before the Senate Comm. on Banking and Currency, 73d Cong., 1st Sess., pt. 15, at 6557 (1934).

[15] S. REP. No. 1455, 73d Cong., 2d Sess. 68 (1934).

[16] 15 U.S.C. § 78p(b).

[17] *See, e.g., Kern County Land Co.*, 411 U.S. at 599; *Reliance Elec. Co.*, 404 U.S. at 425; Blau v. Lamb, 363 F.2d 507, 516 (2d Cir. 1966), *cert. denied*, 385 U.S. 1002 (1967); *Smolowe*, 136 F.2d at 235-36, *cert. denied*, 320 U.S. 751 (1943).

[18] Note, *Involuntariness and Other Contemporary Problems Under Section 16(b) of the Securities and Exchange Act of 1934*, 27 HASTINGS L.J. 679, 680-85 (1976).

[19] 15 U.S.C. § 78p(b); *see also* Foremost-McKesson, Inc. v. Provident Sec. Co., 423 U.S. 232, 242-44 (1976); *Reliance Elec. Co.*, 404 U.S. at 422-25; Roberts v. Eaton, 212 F.2d 82, 85-86 (2d Cir. 1954), *cert. denied*, 348 U.S. 827 (1954).

[20] *See* Note, *supra* note 18, at 684.

[21] *Id.*

[22] Lang and Katz, *Section 16(b) and 'Extraordinary' Transactions: Corporate Reorganizations and Stock Options*, 49 NOTRE DAME LAW. 705, 707 (1974).

[23] *See* Note, *supra* note 18, at 681.

The *Blau* court fell into this trap; the *Lewis* court did not.

The events giving rise to *Lewis v. McAdam* began on December 31, 1981, when Sears, Roebuck and Company acquired Coldwell Banker through Sears' wholly owned subsidiary, Sears Development Corporation ("SDC"). SDC gave Coldwell shareholders the option to exchange their Coldwell stock for cash, for shares of Sears, or for any combination of cash and shares. William McAdam, a director of Coldwell who owned 43,560 Coldwell shares, tendered 30,130 shares for cash and exchanged 13,430 shares for Sears stock. McAdam had acquired 3,300 of his 30,130 shares of Coldwell during a merger of Coldwell with First Newport on September 15, 1981. The subsequent sale of the 3,300 shares, during the Coldwell-SDC merger, yielded McAdam a profit of $62,287.[24]

Harry Lewis, a shareholder of Sears who did not own stock in SDC or Coldwell, demanded that Sears institute a Section 16(b) action to recover the short swing profits McAdam made by acquiring and selling Coldwell shares within a six month period. Sears refused on the ground that "it would be unseemly and contrary to Sears' best interests to seek recovery of an amount SDC had voluntarily offered to pay in connection with an acquisition initiated by Sears."[25] Consequently, Lewis brought suit against Sears, SDC and McAdam, alleging that McAdam violated Section 16(b)'s prohibition against use of inside information in the purchase or sale of securities in less than six months.[26]

Sears, SDC, and McAdam moved for summary judgment, contending that Lewis lacked standing and that McAdam's actions did not constitute a "purchase and sale" under Section 16(b).[27] The district court granted summary judgment without reaching the merits.[28]

Section 16(b) provides in part:

> For the purpose of preventing the unfair use of information which may have been obtained by . . . an insider . . . any profit realized by him . . . within any period of less than six months . . . shall in-

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[24] *Lewis*, 762 F.2d at 801-02.

[25] *Id.* at 802.

[26] *Id.*

[27] For Section 16(b) to apply, the statute requires a "purchase and sale" or a "sale and purchase" of an equity security within a six month period. *See supra* n.12. *See Newmark*, 423 F.2d at 344-45 on what is a purchase and sale. Since the court concluded that Lewis did not have standing, the *Lewis* court did not address the issue of whether McAdam's conversion of stock under the terms of the merger agreement constituted a Section 16(b) purchase and sale. *Lewis*, 762 F.2d at 804.

[28] *Id.* at 802. The Ninth Circuit case is an unreported appeal from the U.S. District Court for the Central District of Cal. under J. Pamela Ann Rymer.

> ure to and be recoverable by the issuer . . . . Suit to recover such profit may be instituted at law or in equity 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 . . . .[29]

The statute defines the group who can bring suit to be the issuer or any holders of securities of the issuer.[30] In *Lewis*, the court decided that those who could bring actions were SDC, Coldwell Banker, or any shareholder of Coldwell. Although Lewis was not a holder of any of Coldwell's securities, he claimed that he had standing to bring a Section 16(b) suit.[31] He reasoned that the purpose of the Exchange Act was to prevent the abuse of insider trading, and therefore, a broad interpretation of the statute was warranted where such abuse would otherwise go uncorrected.[32] Lewis pointed out that it is the public stockholders who are most likely to sue for protection from insider trading. This is partially a result of corporations' reluctance to sue their own directors.[33] He further argued that since Sears had refused to sue,[34] granting standing to Sears' shareholders was the only way to see that McAdam's alleged short swing profits inured to the corporation.[35]

Lewis based his argument on the Second Circuit decision of *Blau v. Oppenheim*.[36] In *Blau*, the defendant was a director of Hansen-Van Winkle Munning Company ("Van Winkle"). He sold 3,154 shares and purchased 6,000 shares of Van Winkle stock within a two month period, deriving short swing profits as defined under Section 16(b). One year later, in September 1964, Van Winkle was merged into M&T Chemical, Inc. ("M&T"), a wholly owned subsidiary of American Can Co. ("American"). Van Winkle sold and transferred its assets and choses in action to M&T in return for American shares that Van Winkle distributed to its American shareholders just prior to the merger and to its extinguishment as a separate corporation.[37] Plaintiff Blau, like Lewis, did not own any shares of the merging company, Van Winkle. Blau had first purchased American shares in 1965, after the Van Winkle-M&T merger. Blau demanded that American or

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[29] 15 U.S.C. § 78p(b) (1982).

[30] *Id. See also Portnoy*, 607 F.2d at 767-68.

[31] *Lewis*, 762 F.2d at 802.

[32] *Id.* at 803.

[33] *Id.* at 803, *relying on* Pellegrino v. Nesbit, 203 F.2d 463, 467 (9th Cir. 1953).

[34] *Lewis*, 762 F.2d at 802. On the question of whether or not Sears had standing, *see infra* note 52 and accompanying text.

[35] *Id.* at 803.

[36] *Blau*, 250 F. Supp. at 881.

[37] *Id.* at 883.

M&T bring suit against Oppenheim. When they refused, he filed suit himself. The court granted standing to Blau, stating that since Section 16(b) would allow recovery to those shareholders of Van Winkle at the time of Oppenheim's transaction and to those who acquired shares after the transaction but before Van Winkle's dissolution, then one who acquired shares only in the surviving corporation subsequent to the disputed transactions should also be able to bring suit.[38]

Despite the outcome in *Blau*, the Ninth Circuit in *Lewis* granted McAdam, Sears, and SDC summary judgment, holding that Lewis did not have standing to initiate a Section 16(b) action.[39] Section 16(b) limits standing to an issuer or one who owns securities of the issuer.[40] The *Blau* court acknowledged at the outset that under a "literal" reading of Section 16(b) Blau never held any securities of the issuer.[41] To grant standing, however, the court in *Blau* stretched the literal definition that limits standing to the merged corporation's successor by formulating the issue as whether or not, when a corporation merges with a wholly owned subsidiary of a parent corporation, a security holder of the surviving corporation *or of its parent* may bring an action under Section 16(b).[42] Since Blau owned no securities issued by the successor to the merged corporation, but only securities of the parent of the surviving corporation, under the established definition he would not have standing. By conferring standing on Blau, the court distorted both the statute's definition and its intent. By allowing security holders of the parent corporation of a surviving corporation to bring suit, the *Blau* court created a whole new category of litigants expressly excluded by the statute.

As the *Lewis* court points out, the *Blau* court completely overlooked the fact that "[t]he starting point for interpreting any statute is the plain meaning of the language used by Congress . . . .[T]hat language, if clear and unambiguous, will . . . be regarded as conclusive . . . ."[43] In fact, in subsequent Second Circuit cases, the *Blau* decision has not been followed.[44]

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[38] *Id.* at 887.

[39] *Lewis*, 762 F.2d at 804.

[40] *See supra* note 29.

[41] *Blau*, 250 F. Supp. at 884.

[42] *Id.*

[43] *Lewis*, 762 F.2d at 804.

[44] *Id.* at 803. *See also* American Standard, Inc. v. Crane Co., 510 F.2d 1043, 1062 (2d Cir. 1974); *Newmark*, 425 F.2d 348, 352 n.2.

## III. Difference Between the *Lewis* and *Blau* Positions

Blau argued that since the successor corporation had no shareholders, the shareholders of the parent corporation should succeed to the right to file suit; otherwise, the right would be lost.[45] Similarly, Lewis argued that since SDC, which became the issuer after Coldwell merged with SDC, had no security holders itself because it was wholly owned by Sears, its parent, Sears and its shareholders should be considered the issuer, and security holders of the issuer (*i.e.*, security holders of Sears such as Lewis) should be able to bring suit against McAdam.[46]

The *Lewis* court rejected his argument for two reasons. First, the cause of action was not lost when Coldwell merged with SDC. Since the federal statute does not address the question of whether the right to initiate a Section 16(b) action survives a merger in which the issuer is extinguished, the court looked to common law and the law of New York, the state in which SDC was incorporated.[47] New York's law codifies the common law rule that choses in action to enforce property rights, including causes of action, vest in the surviving corporation.[48] When Coldwell was merged into SDC, SDC took over all of Coldwell's assets, including the right to initiate a Section 16(b) suit. For purposes of bringing suit, SDC is now called the issuer. By being classified as the issuer in place of the extinguished corporation, SDC, not shareholders of Sears, is empowered to bring Section 16(b) suits for violations by Coldwell directors that may have occurred prior to the merger.

The court's second reason for rejecting Lewis' argument was that there still exists a "class of persons permitted by the language of the statute" to bring suit.[49] Lewis argued that since SDC as a wholly owned subsidiary had no security holders, Sears should be considered the issuer. If Sears were considered the issuer, then shareholders of Sears would, by extension, be shareholders of the issuer and would have standing to initiate Section 16(b) suits for alleged wrongdoing by directors of Coldwell. However, this argument fails because SDC is not a "person who issues or proposes to issue any security."[50] SDC

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[45] *Blau*, 250 F. Supp. at 886.

[46] *Lewis*, 762 F.2d at 803.

[47] *Id.*

[48] *Id. See also* Western Auto Supply Co. v. Gamble-Skogmo, Inc., 348 F.2d 736, 741 (8th Cir. 1965), *cert. denied*, 382 U.S. 987 (1965) (pointing out that at common law a tort claim for the protection of property rights survives).

[49] *Lewis*, 762 F.2d at 804.

[50] 15 U.S.C. § 78c(a)(8).

is technically not the issuer. By inheriting Coldwell's choses in action, SDC has inherited the right to sue as issuer. This means that security holders of Coldwell, the original issuer, or of SDC, the issuer by action of the merger, may initiate Section 16(b) actions.[51]

Assuming arguendo that Sears also has standing to sue as a shareholder of SDC, the court still concluded that it would not help Lewis under its interpretation of Section 16(b). Since a shareholder of the issuer has standing to initiate a Section 16(b) action, Sears, as a shareholder of SDC, has standing to initiate a Section 16(b) action against Coldwell by initiating action against SDC, which is now by definition the inheritor of Coldwell's causes of action. Sears has this power, however, not Lewis. Lewis is only a shareholder of Sears. To have standing, he must have held shares of either Coldwell, the original issuer, or of SDC, the statutory issuer after the merger. The court stated: "We will not confer standing on a plaintiff who falls outside the class of persons permitted by the language of the statute merely because the only parties falling within the class choose not to exercise their right to sue."[52]

The ruling in *Lewis* recognizes that the purpose of the statute to allow Section 16(b) actions is fulfilled. The cause of action survives the merger, vesting in SDC. After the merger, SDC becomes the issuer. As the issuer, SDC has standing to initiate Section 16(b) action if it wants to. Even though Lewis is foreclosed, since the cause of action survives and since there is a class of persons with standing to sue, the *Lewis* court saw no need to stretch the language of the statute to an illogical limit.

## IV. Assessment of the *Lewis* Decision

The *Blau* court's interpretation is premised on the idea that it is necessary to interpret Section 16(b) broadly in order to fulfill congressional intent. In interpreting Section 16(b) in an appeal from a district court decision, the Eighth Circuit found that a broad construction is necessary to ensure that the cause of action survives.[53] The Eighth Circuit agreed with the district court's reasoning that "since . . . 16(b) was intended to protect property rights of the investing public as well as those of the issuing corporation, Section 16(b) must be broadly construed in reaching the decision that the

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[51] *Lewis*, 762 F.2d at 804. "That a merger may result in a corporation succeeding to an action formerly held by an individual is a consequence dictated by the statute." *Id.*

[52] *Id.* (citing *Portnoy*, 607 F.2d at 769).

[53] *Western Auto Supply Co.*, 348 F.2d at 741-43.

chose in action . . . survived."[54] It is true that if the cause of action were to be extinguished along with the issuer in a merger, the inability of the issuer's shareholders on behalf of the corporation to fight insider speculation could result in injustice. Where a broad interpretation is necessary to ensure that the cause of action survives, that interpretation is justifiable.

On the other hand, a broad interpretation of Section 16(b) is not needed once it has been established that the cause of action survives and that a class exists of persons entitled to bring suit. The statute explicitly limits those with standing to issuers or holders of securities of the issuer. However, the *Blau* court's zeal to protect the public went too far by stretching the statute to include persons that Congress never intended. The *Blau* court admitted that the statute doesn't explicitly allow conferring standing on holders of securities of a parent corporation, but it reasoned circularly that it doesn't actually forbid it either.[55] Thus, *Blau* conferred standing on holders of securities of a parent corporation although they are expressly excluded from the statutory language.

The *Lewis* court retreated from the broad interpretation of *Blau*, stating: "We have no constitutional authority to rewrite a statute simply because we may determine that it is susceptible of improvement."[56] In refusing to confer standing on a shareholder of the parent of the successor in interest to the issuer, the *Lewis* court's relatively narrow reading stays closer to the legislative intent than *Blau*'s expansive reading.

Additionally, *Lewis*' determination of who has standing coincides more closely than *Blau's* with the public policy goal of reducing litigation. An important goal of the Exchange Act was to "maximize the ability of the rule to eradicate speculative abuses by reducing difficulties in proof . . . to insure the optimum prophylactic effect."[57] Congress thought the "purpose and reach of the statute . . . would be clear, and litigation seldom necessary."[58] Limiting the class of plaintiffs who can initiate Section 16(b) actions to the issuer or any holders of securities of the issuer reduces litigation.

## V. Conclusion

It may seem that where a successor corporation in a merger has no

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[54] *Id.* at 739.

[55] *Blau*, 250 F. Supp. at 886.

[56] *Lewis*, 762 F.2d at 804 (relying on Badaracco v. Comm'r, 464 U.S. 386 (1984)).

[57] Bershad v. McDonough, 428 F.2d 693, 696 (7th Cir. 1970).

[58] *Newmark*, 425 F.2d at 351; Note, *supra* note 18.

shareholders, if the successor corporation refuses to initiate Section 16(b) action and there has been wrongdoing of the type the statute was designed to prevent, then the parent corporation and its shareholders could be hurt and would have no redress.[59] This is unlikely to be the whole picture, however. The parent corporation can presumably find someone among the holders of the security of the original issuer to file suit if it so desires. Far more likely is the situation in both *Blau* and *Lewis*, where the successor corporation did not want to bring suit because such a suit would be counterproductive in terms of the finances and good will involved in the mergers. Congress certainly knew that corporations make use of wholly owned subsidiaries in mergers. The *Lewis* court emphasized that "[h]ad Congress wanted to discourage this practice by conferring standing on shareholders of a parent corporation . . . it knew how to do so."[60]

As the Seventh Circuit court points out, if Congress were worried about such situations, it could rectify them with a "simple amendment to the [Exchange] Act."[61] By interpreting the statute as literally as possible, the *Lewis* court reaches a fair result without resorting to drafting "judicial legislation."[62]

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[59] *See Lewis*, 762 F.2d at 803.

[60] *Id.* at 804.

[61] *Portnoy*, 607 F.2d at 768 (quoting Lee National Corp. v. Segur, 281 F. Supp. 851, 852 (E.D. Pa. 1968)).

[62] *Id.*