MEMORANDUM

TO: Justice Powell
FROM: Carl R. Schenker

Rider A, p. 20. No. 74-742 Foremost

I think your presumption analysis may be summarized as follows: Section 16(b) defines insiders as including those who own 10%. From the fact of ownership it is presumed that a trading stockholder (1) has access to inside information and (2) has misused inside information. It is, however, irrational to infer (1) and (2) until one who is already an insider purchases and sells.

I don't think this analysis can carry us very far. First, (1) and (2) are not both presumed from the fact of ownership. Second, the perceived irrationality assumes that § 16(b) deals only with dual-transaction abuses and not with single-transaction abuses, while that is the very question at issue.

First. The commentators who have parsed carefully the operation of § 16(b) agree that the section includes two presumptions. Presumption (1) is that 10% ownership gives one inside information. Presumption (2) is that a purchase and sale (or sale and purchase) within 6 months was based on use of the inside information. That is, access is presumed from the fact of ownership, but misuse is presumed from the fact of
a short-swing transaction. (This bifurcation can be seen in the CA 9 analysis. 506 F. 2d 611-614.)

Second: Even if we clarified this point, the analysis in Rider A does not work. The central thrust of Rider A is that it is irrational to conjoin a presumption of access and a presumption of misuse unless both the purchase and sale followed the fact of insider status. In other words, Presumption 2 may only rationally mean that a purchase-and-sale after access to information was based on misuse of information. But note that this position also implies that it is irrational to presume misuse of inside information in the sale of stock unless there was a presumptive misuse in the purchase of the stock. I think that is demonstrably not so. Congress would be entitled to presume that a sale shortly after any substantial purchase reflects a misuse of inside information available after the purchase. (See the appendix for an elaborated discussion). Let's call this Presumption 2'. It could legislate to cover that kind of abuse.
I am not arguing that Congress incorporated Presumption 2' into § 16(b). [Maybe it did as to directors and officers, but we are holding that it didn't as to 10% owners because of the proviso.] I am only arguing that it could rationally enact a statute that incorporated Presumption 2'.

From the foregoing I would make two arguments. First, your statements in Rider A are far too sweeping in their strong suggestion that a statute including Presumption 2' might be unconstitutional. Second, the very question that this opinion addresses is whether or not the proviso was intended to negate Presumption 2' for stockholders. If Presumption 2' were irrational, it would be valid to argue Congress couldn't have intended it. But since Presumption 2' is rational, Rider A is a bootstrap argument. (Please note that the CA 9 argument based on presumptions recognized this point. 506 F. 2d at 611-614. It therefore argues not that Presumption 2' is irrational, but that Congress demonstrated that it wanted Presumption 2 by deleting tippee liability. The argument is that tippees were
outsiders, as are 10% owners before the purchase. Therefore the deletion of tippee liability shows an intention to exclude outsiders, including those who owned less than 10% before purchase. This argument, however, does not work because 10% owners are insiders after the purchase, while tippees are always outsiders. The deletion of tippee liability therefore proves nothing about Presumption 2 or Presumption 2' when it is conjoined with Presumption 1.)

**Suggestion:** I wrestled with this presumption argument before rejecting its inclusion in the draft. But I am now perfectly clear on its bootstrapping nature. And I think the weakness of the CA 9 argument demonstrates that it can't be remedied. For that reason I prefer the alternative suggested in your previous memo to me. The liability without fault argument is not a bootstrapping argument. Congress knew it was imposing liability without fault and definitely did not want to make it too broad. Of course, that desire doesn't answer the question whether it chose to incorporate Presumption 2 or Presumption 2', but it allows a more coherent and analytically sound policy argument. You seem to feel that my argument on this point was not strong enough. I recommend strongly that we rework my section together to tone it to the pitch you want rather than sticking with the presumption analysis.

**Appendix:** Imagine for a moment that Congress deliberately and unambiguously set out to pass a statute that
covered both dual-transaction abuses and single-transaction abuses. It could follow a thought-process like this:

(1) One who purchases over the 10% level may or may not have made that purchase on inside information. (If the purchase was based on inside information, that information was not derived from the fact of relationship to the corporation, but from some other source.) When he sells within 6 months there are three possibilities. (a) He had inside information when he bought and intended to sell on the short-swing.

(b) After he became an insider, he acquired information and sold on the short-swing. (c) Both the purchase and the sale were innocent.

(3) As you have pointed out to me, one who purchases a substantial block usually does so for purposes of long-term investment (especially when he has the prospect of control).

(4) Therefore, when a substantial purchaser sells within 6 months, the profits can be taken out of the sale because (3) makes it rational to assume a significant probability of either (a) or (b) abuse.

In a (b) abuse situation of an innocent purchase followed by an abusive sale, the rationality stems from essentially the same two presumptions that operate at present in § 16(b). When one becomes an insider, he has access to inside information. When such a person sells within 6 months he was trading on that information. The rationality for covering (a) situations is
is slightly different, but it need not be discussed. Congress would be entirely justified in saying that (b) abuses were so likely that the rule was justified on that basis alone. Since you can't tell an (a) abuse from a (b) abuse, Congress would be entitled to subsume both under the same rule.

The possibility remains that many (c) situations of an innocent purchase followed by an innocent sale would be covered by this statute. But it is not irrational to cover these situations in order to reach all of the (a) and (b) situations. This is especially true because the "only" penalty imposed upon the (c) people is loss of profits. This is liability without fault, but of a very limited variety.

Carl
December 22, 1975

No. 74-742, Foremost-McKesson, Inc. v. Provident Securities Co.

Dear Lewis,

I am glad to join your opinion for the Court in this case.

Sincerely yours,

Mr. Justice Powell

Copies to the Conference
December 22, 1975

Re: No. 74-742 - Foremost-McKesson v. Provident Securities Co.

Dear Lewis:

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Mr. Justice Powell

cc: The Conference
December 23, 1975

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Copies to the Conference
RE: No. 74-742  Foremost-McKesson, Inc. v. Provident Securities Company

Dear Lewis:

I agree.

Sincerely,

Mr. Justice Powell

cc: The Conference
December 31, 1975

RE: No. 74-742 Foremost-McKesson, Inc. v. Provident Securities Company

Dear Lewis:

I agree.

Sincerely,

Mr. Justice Powell

cc: The Conference
Throat clearing. I have been working my way up to preparing a memo that would allow us to discuss the basic strategy that the opinion should take. My strategical problem is that there are at least two cases not presented here that we want to hold harmless in this opinion (as I understand our previous discussions). This may be impossible, but that is a longer range matter than the immediate problem that has arisen so I will discuss that matter at the second part of the memorandum. I will turn first to my shorter range problem: Did the Conference vote the right way in Provident? (Please read on before you come to the conclusion that I'm a sore loser.)

A. The basic outcome.

As you know, the Court's previous foray into the meaning of the proviso in § 16(b) was in Reliance Electric. There the question presented was what the words "at the time of . . . sale" meant. They were held to mean that a beneficial owner could "minimize" his liability by making step sales.

Reliance Electric's facts are easily summarized: The stockholder bought 1/5% of the corporation, then sold in two blocks of 6% and 9%.

The stockholder contended that the proviso "both at the time of the purchase and sale" excluded any liability for either sale. But the Court found that question not to be properly presented in the case. Thus it confined itself to the further contention that the second sale should not be covered. The Court held that the "plain meaning" of the phrase "at the time of . . . sale"
was that the second sale was excluded from operation of the statute because after the 6% sale, a 15% owner was no longer a "beneficial owner of more than 10%." Seems sound enough.

Now let's consider Provident. Provident became a more XXX than XXXX 10% owner XXX in a single purchase of 15%. It then sold XXXX 6%. The Conference has voted to hold that the words "both at the time of the purchase . . ." mean that since Provident was not a 10% owner at the time of the original purchase, its subsequent sale cannot be matched against that purchase. Seems sound enough.

The problem is that if Provident is right, Reliance XXXXX XXX MUST be wrong. Under Provident the first 10% XXXXXXXXXXXXXXX of a beneficial owner's holdings can never be matched against subsequent sales. Consequently, the "at the time of . . . sale" language cannot be necessary to protect the XXX stepped down sales.

The problem is that if Provident is right, Reliance MUST be wrong. The holding of Reliance is that some of the original 10% of a XXXXXXXXXXXXXXX beneficial owner's holdings can be disposed of without liability if he has XXXXX previously disposed of enough to bring himself down below the 10% mark. But under Provident the original 10% would always be protected from liability, because they are transactions not to be construed as a statutory "purchase."

Let me demonstrate: Imagine that all four of the following transactions take place within 6 months--

- an 11% purchase
- a 4% purchase
- a 6% sale
- a 9% sale.

Now, under Stella plus Reliance, the result of an XXX 11 + 4 - 6 - 9 sequence would be to hold the stockholder for 6.

(The XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX XXXXX transaction XXXXXX is a
The problem is that if Provident is right Reliance must be wrong. Let me demonstrate: Imagine that all three of the following transactions take place within 6 months—

- a 15% purchase
- a 6% sale
- a 9% sale

In World A, Stella and Reliance are the controlling cases. The stockholder would therefore be liable for 6%. In World B Provident is the controlling precedent. The stockholder is liable for nothing. The trouble is not that the amount of liability changes. The trouble is that Provident makes Reliance irrelevant. Reliance is only pertinent to the extent that sales made after one gets to less than 10% are safe. But they will always be safe under Provident because that case holds that the "purchase" by which one becomes a beneficial owner will never be a statutory "purchase." Therefore no sale can be matched against it, whether or not the stockholder held 10% at the time of the sale.

I have had some trouble conveying some of this to people orally. But in order to be sure the point is clear let me repeat it. Reliance's holding would only apply when a stockholder was selling his "basic" 10% because at no other time would he fail to be a "more than 10% owner" at the time of a sale. But Provident holds that the transaction by which one acquires "more than 10%" status is not a "purchase." Therefore when a stockholder sells out that stock, there is no "purchase" for his sale to be matched against. Accordingly, the Provident construction of "at the time of the purchase" renders Reliance's construction of "at the time of the sale" superfluous.

Now, one can take two basic approaches. One could say
that Congress didn't realize this; it's all a mistake; Provident is right; the language is superfluous; it wasn't evident that the language was superfluous in Reliance because we weren't considering the whole MXX clause.

Or one could seek to find a way to prevent the "at the time of sale" language from being superfluous. MXX MXX Believe it or not, there are three ways.

Let me start first with the most plausible. As you may recall from my original memorandum in this case, I said that the proviso could be given meaning by construing it to permit minimization of MXX liability by step purchases. (Obviously this is the converse of Reliance.) That would work out as follows: Imagine that the following three transactions all occur within six months--

- 10% purchase
- 6% purchase
- 15% sale

Under the Schenker interpretation this 9 + 6 - 15 sequence would result in liability of 6%. That result would obtain because of the language "at the time of the purchase." At the time of the first "more than MXX purchase the stockholder was not a 10% owner, so the 9% MXX "buy" was not a statutory "purchase." MXX MXX MXX But the 6% purchase makes one a statutory insider under the general principle of Stella (which, of course, also applies if one buys all 15% in one "swell foop"). Therefore one is an insider when all 15% is sold, but only MXX 6% of the "sales" have a purchase to be matched against. MXX MXX MXX To emphasize the role of Stella in this case, let's rename...
this the Stella-Schenker approach.

Reliance retains its role under the Stella-Schenker approach, as can be seen by imagining the following four transactions to occur within 6 months--

- a 7% purchase
- a 8% purchase
- a 6% sale
- a 9% sale.

This 7 + 8 - 6 - 9 sequence would yield liability of 6% under the Stella-Schenker interpretation because of Reliance. "At the time of the [8%] purchase," the stockholder made a matchable transaction under the statute. All 8% of that amount could be recaptured in later sales but for Reliance. Because under Reliance the 6% sale means that "at the time" of the 9% sale (which includes 2% of the Stella "purchase") the stockholder was not a more than 10% owner. Thus Reliance and the "at the time of sale" language have meaning under the Stella-Schenker approach. Note that in this context under Provident, Reliance would be irrelevant: neither the 6% nor the 9% "unloading" is a "sale" because "at the time of the purchase" the stockholder was not a "more than 10%" owner.

This Stella-Schenker-Reliance approach seems relatively straightforward. As I mentioned in my original memo, Loss adopts it. But he does so because he views the "at the time of the purchase" language to be ambivalent and thinks this interpretation comports with the purposes of the XXX statute. He does not appear to notice that this interpretation is necessary to avoid rendering the Reliance interpretation of "at the time of sale" superfluous.

OK. That is approach #1 to a nonsuperfluous construction of XXXXXXXXX "at the time of sale." Under that interpretation both "at the time of the purchase" and "at the
time of . . . sale" are relatively straightforward. 

It is necessary to sketch another kind of case to complete the picture under the Stella-Schenker-Reliance interpretation. Imagine the following four transactions all occur within a six month period:

- an 11% purchase
- a 4% purchase
- a 6% sale
- a 9% sale

Under the Stella-Schenker-Reliance approach the result in this sequence is liability for 6%. The "Schenker" aspect of the approach is not relevant to this case because there are no step purchases. Stella makes the entire 15% of holding a potential "purchase," but Reliance saves harmless the 9% sale. Under Provident, of course, liability would be 4%. The 11% holding was not a "purchase," so the 4% is the only "purchase" available against which to match the 6% sale.

Ok. That fleshes out the reasonable interpretation of "at the time of the purchase" which leaves the Reliance interpretation of "at the time of . . . sale" not superfluous. Now let's look at some of the other ways to prevent "at the time of . . . sale" from being superfluous.

Let's call approach # 2 the Zero interpretation. Under the Zero interpretation, one could construe "at the time of . . . sale" to mean that the stockholder must hold "more than 10%" after the sale. In other words, unless one had "more than 10%" left after the sale in a purchase/sale case, one would not be liable. Imagine

* Please note that there are two ways to prevent the phrase "at the time of . . . sale" from being superfluous. One is to construe "at the time of the purchase" in such a fashion that "at the time of . . . sale" can still mean what it was said to mean in Reliance. That's Interpretation # 1. The other is to say that Reliance was wrong, and that at the time of . . . sale" means something other than what Reliance said. That's Interpretation # 2.
this case anyway you like to take it: it is a loser. For illustration, imagine the following three transactions within six months:

- an 11% purchase
- a 4% purchase
- a 15% sale

Under Provident, the stockholder would have liability for 4%. Under Stella-Schenker-Reliance, the stockholder would be liable for 15% (not having availed himself of Reliance). Under the Zero approach he would have liability for nothing, since he didn't have "more than 10%" left after the sale.

But the Zero approach does make 'at the time of . . . sale" mean something. Combined with Provident it prevents the superfluity of the phrase that results when the Reliance approach is combined with Provident. There are two big problems with the Zero approach. The first, obviously, is Reliance. The more important is that everybody agrees that the statute would really be gutted by such an approach, and that it can't mean this.

The Zero approach would be bad law, but at least it prevents superfluity and not a great deal of tortured construction is necessary to reach it. Approach # 3, to which we now turn, would be very tortured but it also avoids superfluity. Let's call approach # 3 the Juggernaut approach. (Totally arbitrary.) Under the Juggernaut approach, one would construe (as in # 1) the "at the time of the purchase" phrase. Let me illustrate the result before trying to explicate the interpretation. Imagine the following three transactions within six months:

- a 9% purchase
- a 6% purchase
- a 15% sale

Under the Provident approach, liability here will be nothing. Under the Stella-Schenker-Reliance approach liability would be 6%. 
The Juggernaut approach would interpret the proviso to mean that whenever a Provident insider made an additional purchase he would be liable for sales matched against all "purchases," whether or not they themselves were purchases that would have passed muster under Provident. The only limitation on liability is that in Reliance for step sales. To paraphrase, under Juggernaut nonstatutory purchases becomes statutory "purchases" when a statutory "purchase" is followed by a statutory "sale." Let me illustrate this before I try to justify it.

First, imagine the following three transactions within six months:

- a 9% purchase
- a 6% purchase
- a 15% sale

Under Provident there would be no liability here. Under Stella-Schenker-Reliance there would be 6% liability. Under Juggernaut there would be no liability. The Provident test is applied to determine that neither the 9% nor the 6% purchase was a statutory "purchase." Then the statutory "sale" has no transaction against which to be matched. Second, imagine the following three transactions within six months:

- an 11% purchase
- a 4% purchase
- a 15% sale.

Under Provident, there would be 4% liability. Under Stella-Schenker-Reliance there would be 15% liability. Under Juggernaut there would be 15% liability. The Provident test is utilized to identify the 4% purchase as one made by a statutory insider. The 4% purchase is thus a statutory "purchase" followed by a statutory "sale." Under Juggernaut such behavior
converts nonstatutory "purchases" within six months of the "sale" into "statutory purchases". Therefore all 15% of the liability is capturable.

Reliance, however, would also enter any case where there were step sales to allow minimization of liability. Thus, in an 11 + 4 - 6 - 9 sequence, liability under Juggernaut would be 6%. Under Provident, of course, it would be 4% and under Stella-Schenker-Reliance it would also be 6%.

To hazard a generalization that I am not sure would prove out logically in all cases, the Juggernaut liability would be the same as Stella-Schenker-Reliance in any case where one made a purchase after becoming a Provident insider, but would be the same as in Provident in any case where no purchases were made after becoming a statutory insider. Obviously, neither "at the time of the purchase" nor "at the time of . . . sale" is treated as superfluous.

Before I try to justify Juggernaut on the language of the statute, let me say why it makes some sense as a theoretical matter. Compare Stockholder Innocent with Stockholder Pernicious. Innocent engages in a 7 + 8 - 15 sequence. Under the basic theory of Provident, he is a good guy because neither of his purchases was made on the basis of inside information. He is therefore entitled to sell his holdings free of liability. Pernicious engages in an 11 + 4 - 15 sequence. He is a real bum. His 11% holdings gave him inside information. That put him in a position to learn inside information indicating that a killing could be made in the stock. He then rushed out, bought an additional 4% and unloaded all of it. He is a pretty low form of life.

Now, does the statute allow us to draw this distinction? The proviso reads in full: "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 . . . " The use of the word "transaction" shows that "purchase and sale" come as a unit in the statute. Pernicious proceeded by means of a nonstatutory purchase + a statutory purchase + a statutory sale. The statutory purchase + the statutory sale constituted a statutory "transaction." Thus he has realized profit on "any purchase and sale" while being a beneficial owner "both at the time of the purchase and sale." Although the original purchase would not have been a statutory purchase, the second purchase and the sale are clearly within the statute. Since the stockholder has acted on the basis of inside information, we will get him for all his sales.

I guess I don't need to say that the rationale is more convincing than the attempt to twist it out of the statute. I think this is a rather tortured approach.

Let's turn finally to the Allis-Chalmers approach. The 7th Circuit has construed the proviso in the following fashion: The use of the word "transaction" in the proviso shows that a purchase/sale and a sale/purchase should be thought of as a unit. The proviso therefore should be read to mean "both at the purchase/sale, or the sale/purchase." Thus, when one looks to time, one asks only a single time question in each case: What was the stockholder before the initial transaction. The "both" is the first part of a "both . . . or" construction. Thus there is no second time question in a given case. Under this construction, "at the time of . . . sale" is not superfluous. Rather, it is misconceived, unnecessary.
The Allis-Chalmers approach has two **XXX** difficulties. One is that Reliance is on the books. The second is that "both . . . or" is **very** unusual English.

So, there you have **XXX** solutions to the fact that Provident renders the Reliance interpretation of "at the time of . . . sale" superfluous: (1) Say the language is superfluous and Reliance was wrong; (2) adopt the stepped-up purchase analysis (Schenker); (3) the Zero approach; (4) the Juggernaut approach; and (5) the Allis-Chalmers approach.

Now turn for a moment to the "both at the time of the . . . sale or purchase" part of the proviso. It should be noted that the most likely construction of that part of the proviso is that one must own "more than 10%" before the sale and after the purchase. Under that construction the "at the time of . . . sale/purchase" would not be superfluous, because it would prevent the application of liability in an 11 - 4 + 2 sequence. Of course, under the Allis-Chalmers approach there might be liability in an 11 - 4 + 2 sequence, since the sale/purchase transaction would create a profit when one was a "more than 10% owner" "at the time of the sale/purchase"--i.e., before the sale. But that result is also out of whack with Reliance. Therefore I don't think that the latter part of the proviso casts much light on the first part.

My problem is that I don't know how to write the Provident result under the shadow of Reliance. What do I say about it? What is Justice Stewart in particular going to do when he realizes that Reliance looks pretty silly in light of Provident.

Let's look at our options. The first option is to plow right ahead and simply dump on Reliance on the **XXX** theory that
in fact the language is superfluous: either because it is out-and-out is superfluous or because the Allis-Chalmers approach is correct. The second alternative is to give meaning to the "at the time of . . . sale" language other than Reliance.

This means starting out by dumping on Reliance not as superfluous but as wrong. Then we adopt the Zero approach, the Juggernaut approach, or the Schenker approach. The Zero approach is simply unacceptable; the Juggernaut approach is very tortured; the Schenker approach comes easiest. It is tortured to the extent that "at the time of" means simultaneously with purchases and before sales. But that basic fact of "at the time of" meaning different things in different areas is almost a necessity of the statute. If it doesn't have that flexible meaning and Provident is correct, there will be no liability in an 11 - 11 + 11 situation, because if "at the time of" means "before," you never get the 11 - 11 + 11 stockholder.

Those are all two alternatives. There is a third possibility: ignore all this. Then you end up with egg on your face rather than Justice Stewart, though it is possible no one but me will ever notice this. I have talked to Stewart's clerk and Blackmun's clerk assigned to this case and neither of them had thought of the problem. We could also say that we leave the possibility that Juggernaut is the real meaning until we have a case presenting the meaning of the "at the time of . . . sale" language. But that obviously just points up what a mess Reliance has created. Personally, I haven't changed my initial view that the Schenker approach is correct, but I am yours to command.
B. The strategic problem.

I had planned to discuss this at greater length, but the first part of the memo is too long to allow that. As I said, there are two cases we want to hold harmless in this opinion. One is Case A: a person buys 5% of a corporation’s stock, becomes a director, and sells his stock all within six months. The other is Case C: a "more than 10% owner" sells below 10% and repurchases above 10%. I consider our case Case B.

I label the three cases A, B, and C because in an important respect the way we decide Case B will inevitably control either Case A or Case C.

Case A and Case B are very similar cases. In both an "outsider" performs an event that makes him an "insider" and then unloads his stock. In Case A he becomes a director; in Case B he buys his stock. Now, you are familiar from our previous discussions with the dual-transaction analysis of § 16(b). Under that approach, there should be no liability in either Case A or Case B. But, as I’ve said before, those results would stem not from the proviso (which of course doesn’t even apply to directors) but from the basic structure of the statute. But the proviso was put in. It says that "More than 10%" stockholders have to be such "both at the time of the purchase and sale." There is no such requirement for directors. If the proviso controls this case as to stockholders, then by negative implication the result would be the opposite without the proviso. Since the proviso doesn’t apply to directors/officers, by negative implication Case A is a situation for liability. It is enough for an officer or director that he be such either at the time of purchase of his stock or at the time of sale. The only way to avoid this conclusion is to say that the proviso deals with another
problem entirely. But even the commentators who support dual-transaction analysis can't suggest what that might be.

The reason this point is troubling is demonstrated by Reliance. In Reliance the Court chose to deal with just a portion of the statute; it now appears that the Court's hands are somewhat locked by that error. The same thing could happen here. If the Court relies on the proviso when it shouldn't because the dual-transaction analysis is right, then the Case A is controlled by that approach when the case comes up.

I think we should rely on the proviso (assuming that the Court presses on on its present path). I don't see what else the proviso might mean. I think Case A should make for liability, even though the statute may primarily be aimed at dual-transaction abuses. I am prepared to write Provident that way—but somebody has to tell me what to do about Reliance.