DIRECTORS' AND OFFICERS' LIABILITY
OPTION COMPENSATION AND SHORT-SWING PROFIT RECAPTURE

JOSEPH M. MCLAUGHLIN
SIMPSON THACHER & BARTLETT LLP

JULY 15, 2001

The award of stock options to directors and officers of companies with a class of equity securities registered under the Securities Exchange Act of 1934 may inadvertently thrust the grantee into the short-swing profit recovery provisions of § 16(b) of the Act. While traditional cash for stock purchases and sales are evaluated with relative ease, the application of § 16(b) to "unorthodox" securities transactions such as the granting of options to a statutory insider represents a tripwire for the unwary. Because directors and officers liability insurance policies typically exclude coverage for claims seeking disgorgement of trading profits under § 16(b), it is essential that directors and officers receiving options and planning trades in their company's securities understand the applicability of § 16(b).

Section 16(b)

Section 16(b) is the original federal securities law provision targeted at insider trading.[1] In order to curb profit-taking by statutory insiders on the basis of non-public information, Congress chose a relatively arbitrary rule capable of easy application. The general rule of § 16(b)'s short-swing profit recapture provisions is simple: any profits realized by an officer or director (or beneficial owner of more than 10% of any class of equity securities of a publicly traded corporation) from a non-exempt purchase and sale, or sale and purchase of any equity security of such company occurring within a six month period must be disgorged to the company.[2] The rule is mechanically applied, imposing strict liability without regard to the purpose of the trades or actual use of material, non-public information. If relevant trades occur within six months of each other and yield a profit, the insider must disgorge the profit to the company even in the absence of wrongdoing. To encourage enforcement, the Act authorizes federal civil actions to be brought on behalf of the company by a qualified shareholder if the company declines to institute litigation within sixty days of a demand.[3]

Profits for § 16(b) purposes are computed by arbitrarily matching purchases with sales within a six-month period in order to maximize the amount of profit recoverable by the company. Thus, even if overall trading within a particular six-month period results in a net loss, the majority view matches the lowest purchase price against the highest sale price within the period to salvage a recoverable profit from an out-of-pocket loss.[4] In calculating a seller's short-swing profit, however, courts have generally held that regular, periodic cash dividends are not part of the "profit" recoverable under § 16(b).[5]

Section 16(b) and Derivative Securities Generally

The award of options — derivative securities that grant the holder the right to buy or sell property at a fixed or floating price – has become a fixture of executive compensation. A "call option" gives the holder the right to buy from the grantor or seller a specified number of shares at an agreed price at any time before the option's expiration date. The holder of a call option hopes that the price of the underlying security will rise between the date the option is granted or purchased and the time it is exercised. A "put option" (infrequently held by directors and officers) entitles the holder to sell a specified number of shares within a specified time at a specified price (the "strike price") to the grantor or seller of the put. The holder of a put option hopes that the price of the security will fall between the date the option is granted or purchased and the time it is exercised so that he can buy it at a price lower than the strike price, the price at which the seller of the put is obligated to purchase the stock if it is tendered.

The text of section 16 does not mention options. Prior to 1991, whether options qualified as "equity securities of [the] issuer" within the meaning of § 16(b) engendered considerable controversy. In 1991, the SEC attempted to resolve the controversy by amending its rules under Section 16(b) to clarify how the statute applies to options and other derivative securities.

Because the value of a derivative security is a function of the value of the underlying equity security, the SEC asserted that generally, "holding derivative securities is functionally equivalent to holding the underlying equity securities for purposes of Section 16."[6] Reasoning that the point of acquisition or disposition of a derivative security is the time at which inside information might be useful, the Commission provided in SEC Rule 16b-6 that the acquisition or disposition of a derivative security with a fixed exercise price – not its exercise or conversion — is the triggering event for matching under § 16(b). While the acquisition of a derivative security with a fixed exercise price, such as a call or put option, is deemed a "purchase" of the underlying stock under § 16(b), the exercise or conversion of that derivative security is a non-event for § 16(b) purposes.[7] This rule reflects the SEC's view that the exercise of a fixed price option merely changes the form of beneficial ownership of the underlying security from indirect to direct without altering the opportunity for insiders to profit. Thus, it is important to remember that for purposes of computing potential short-swing profit, the acquisition of a call option by a director or officer may be matched against (1) off-setting dispositions of call options *or* (2) dispositions of the underlying equity security within a six-month period. In short, the Rule treats the acquisition or disposition of an option with a fixed exercise price just as if the statutory insider had traded the underlying security itself.

How is recoverable profit determined when options are involved? With respect to offsetting transactions in the same security, the difference between the actual price paid and the money received in short-swing transactions must be disgorged. As to "mixed" transactions (involving different derivative positions and/or equity securities), the difference in the market price of the underlying equity security on the dates of purchase and sale must be disgorged. For example, a company's stock trades today at $50 per share and call options exercisable at $40 are available at $5 per share. Assume a director purchases 1000 call options for $5,000, and within six months exercises the options and sells the shares at the market price of $70. Because the exercise of the options is a § 16(b) non-event, the purchase of the options is matched against the sale of the underlying shares. Accordingly, the director must disgorge the difference between the market price of the underlying shares on the date of the purchase of the options ($50) and the market price of the shares on the sale date ($70): recoverable profit of $20 per share.

Courts in the Second Circuit have delved into the arcana of derivatives to clarify further the circumstances in which transactions involving options may implicate § 16(b). In *Magma Power Co. v. Dow Chemical Co.*,[8] the Second Circuit addressed whether all options arising out of the same instrument must have a fixed exercise price before the creation of any of the constituent options can be deemed a "sale." In September 1994 a statutory insider acquired an option to acquire 857,143 Magma shares at an exercise price of $28.25 per share. Because the option granted the insider the right to obtain shares at a predetermined price, the acquisition of the option constituted a § 16(b) purchase. The purported matching "sale" occurring within six months of the September 1994 option acquisition flowed from the insider's issuance in 1991 of subordinated notes, which were exchangeable at the noteholder's option for a fixed number of Magma shares. In the event of exchange, the insider had a contractual right to pay noteholders cash in lieu of Magma shares, in an amount equal to the market value of the shares on the date the noteholder elected to exchange. Thus the notes contained two options: a fixed price option in favor of the noteholders, and a floating price call option in favor of the insider. Less than six months after the insider's September 1994 acquisition of the option (the "purchase"), the insider delivered 882,259 shares of Magma to noteholders who exercised their exchange rights (it did not exercise its right to retain Magma stock and pay its cash equivalent to tendering noteholders).

Citing the existence of the floating price call option, Magma contended that the notes were not derivatives because they lacked a fixed exercise price. Magma alleged that the insider's unexercised right to retain the Magma stock and pay the cash equivalent to noteholders thus transformed the exchange into a "sale" by the insider at a price higher than Magma shares' value at the time of the September 1994 option acquisition ("purchase").

Affirming a grant of judgment on the pleadings in favor of the insider, the Second Circuit held that the delivery of shares in late 1994 pursuant to note conversions did not constitute a "sale." Rejecting the notion that all options arising out of the same instrument must have a fixed exercise price before the creation of any of the constituent options can be deemed a "sale," the court held that the notes were derivative securities that were "sold" for § 16(b) purposes in 1991 when the fixed price call option was granted and the conversion rate set. The insider's retention of the right to repurchase the shares it was otherwise obligated to deliver by paying noteholders the prevailing market price did not affect that conclusion. Accordingly, the insider's decision to deliver the shares and not repurchase them could not be deemed a "sale," but rather the closing of a derivative security position as a result of its exercise or conversion, which is exempt from the operation of § 16(b).

Section 16(b) and Convertible Securities

Because convertible securities qualify as "derivative securities" for § 16(b) purposes only if they have a fixed exercise or conversion price,[9] courts have divided on whether securities such as convertible preferred stock or debentures with a hybrid conversion pricing structure (one part fixed and one part floating) qualify as "derivative securities." In *Lerner v. Millenco, L.P.*,[10] the court held that convertible debentures with a hybrid conversion price qualify as "derivative securities" because they have a maximum conversion price. Accordingly, there is authority in the Southern District that conversions of such debentures into common stock are non-events for § 16(b) purposes.

In *Levy v. Clearwater Fund IV, Ltd.*,[11] a district court in Delaware recently disagreed with *Lerner*, holding that convertible preferred stock with a fixed and floating conversion price does not qualify as a "derivative security," so that conversions of the preferred stock by insiders may constitute purchases under § 16(b). The "holder of a 'hybrid' option," the court reasoned, "can choose the floating component in order to exploit insider information by the timing of the exercise and consequent fixing of the 'acquisition' price. The opportunity for profit, as well as for abuse of insider information, is more within the control of the option holder [upon conversion] and, consequently, more deserving of oversight." Thus, until the SEC or additional case law clarifies the applicability of § 16(b) to convertible securities with hybrid conversion features, prudent directors and officers will structure their trading decisions with an eye toward compliance with both approaches.

ENDNOTES

1 The SEC has expanded the federal law prohibitions against insider trading through SEC Rules 14e-3, 10b5-1, 10b5-2 and Regulation FD. While beyond the scope of this article, familiarity with these provisions is essential for directors and officers seeking to formulate appropriate trading plans.

2 Determining who is an officer or director for purposes of the statute is not always easy. The SEC has defined "officer" as a "president, vice president, secretary, treasury or principal financial officer, comptroller or principal accounting officer, and any person routinely performing corresponding functions" in the company. 17 C.F.R. § 240.3B-2. Consistent with SEC releases indicating that the Commission does not consider an employee's bare title as an officer automatically to bring the officer within the scope of the statute, the Second Circuit has held than an employee's functions and access to non-public information, rather than his or her title, determines "officer" status within the meaning of §16(b). This approach sensibly recognizes that many businesses grant the title of vice president to employees who do not have significant managerial or policymaking duties and are not privy to inside information. *See C.R.A. Realty Corp. v. Crotty*, 853 F.2d 562 (2d Cir. 1989).

3 15 U.S.C. § 78p(b); *see Gollust v. Mendell*, 501 U.S. 115, 121 (1991). Section 16(a) facilitates the recovery of short-swing profits by requiring statutory insiders to disclose any change in ownership within ten days of the end of the month in which the change occurs. The insider makes the disclosure in a Form 4 filed with the SEC, which sets forth the transactions in a manner in which it will be readily apparent whether purchases and sales resulted in short-swing profit.

4 *See Smolowe v. Delendo Corp.*, 136 F.2d 231, 239 (2d Cir.), *cert. denied*, 320 U.S. 751 (1943).

5 *See, e.g.*, *Blau v. Lamb*, 363 F.2d 507, 528 (2d Cir. 1966), *cert. denied*, 385 U.S. 1002 (1967).

6 Ownership Reports and Trading by Officers, Directors and Principal Security Holders, Exchange Act Release No. 28,869, [1990-91 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 84,709, at 81,258 (Feb. 8, 1991).

7 *See* 17 C.F.R. § 240.16a-1(c)(6); 17 C.F.R. § 240.16b-6(b).

8 136 F.3d 316 (2d Cir. 1998).

9 17 C.F.R. § 240.16a-1(c)(6).

10 23 F. Supp.2d 337 (S.D.N.Y. 1998).

11 2000 WL 152128 (D. Del. Feb. 2, 2000).