DIRECTORS' AND OFFICERS' LIABILITY

EXEMPTIONS TO SHORT-SWING PROFIT RECOVERY

JOSEPH M. MCLAUGHLIN*
SIMPSON THACHER & BARTLETT LLP

JUNE 14, 2007

The application of exemptions from the strict liability, short-swing profit recovery provisions of Section 16(b) of the Securities Exchange Act of 1934 has proved challenging. In 2005, the SEC amended Rule 16b-3 - which exempts transactions between an issuer and its officers and directors involving issuer equity securities - and Rule 16b-7 - which exempts transactions pursuant to certain mergers, consolidations, and share reclassifications - in response to a Third Circuit decision that imposed additional requirements for both exemptions. The SEC clarified that, subject to board or shareholder approval conditions, Rule 16b-3 exempts acquisitions of issuer equity securities by directors and officers from an issuer regardless of whether there is a compensatory purpose, and that Rule 16b-7 does in fact exempt transactions structured as reclassifications because the reclassification of shares from one form into another, where the shareholder's economic stake in the company remains essentially unchanged, presents minimal risk of abuse of inside information. A Delaware federal court recently held in *Levy v. Sterling Holding Co.*[1] that two amended SEC rules clarifying important exemptions to the short-swing profit recovery provisions of Section 16(b) are entitled to deference and should be applied retroactively. These clarifications and their subsequent application by a Delaware district court should come as welcome news to directors and officers of companies with a registered class of securities.

Section 16(b)

Section 16(b) is the original federal securities law provision targeted at insider trading.[2] 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 Section 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 percent 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.[3] The

---

* **Joseph M. McLaughlin** *is a partner at Simpson Thacher & Bartlett.* **Patrick M. Connorton**, *a summer associate at the firm, assisted in the preparation of this article.*

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 60 days of a demand.[4]

Profits for Section 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.[5] 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 Section 16(b).[6]

Section 16(b) Exemptions

The SEC has exempted certain categories of transactions from the reach of Section 16(b) because they are not prone to abuse. Under Rule 16b-3, for example, short-swing profit recapture does not apply to stock transactions between an issuer and its officers or directors. The SEC recognizes that such transactions are distinct from market transactions because they do not afford an opportunity to profit from non-public information given that the issuer presumably has access to the same information as its officers and directors. Existing state law fiduciary duties police any potential self-dealing arising from such transactions.[7] Traditionally, Rule 16b-3 has been used to exempt employee benefit plans and other compensatory programs. In fact, when the SEC streamlined Rule 16b-3 in 1996, it did so with the express hopes of reducing regulator preferences for cash compensation over stock compensation. At the time, the SEC noted that stock compensation was a "legitimate and increasingly popular mechanism for an issuer to compensate persons in its service."[8] Nonetheless, the SEC stated in a 1996 release that a transaction between an issuer and its directors and officers "need not be pursuant to an employee benefit plan or any compensatory program to be exempt, nor need it specifically have a compensatory element."[9]

Rule 16b-3 is the most frequently litigated exemption to Section 16(b).[10] In a recent high-profile example, Tyco sued Dennis Kozlowski, its former CEO, seeking to disgorge $30 million in short-swing profits for which the 16b-3 exemption had been claimed.[11] Tyco alleged that Kozlowksi had improperly invoked the exemption for transactions that were not approved by Tyco's board of a directors or a majority of its shareholders, as the Rule requires. The suit, which is ongoing, represents an attempt by Tyco to reclaim some portion of the millions that the now-incarcerated Kozlowski allegedly stole from the company.

Under Rule 16b-7, the SEC exempts from Section 16(b) transactions pursuant to mergers or consolidations where the security acquired or sold is of a company that owns 85 percent of the equity or assets of all the companies involved in the merger or consolidation. This exemption

typically is relied on when companies employ mergers to reincorporate in a different state or reorganize their corporate structure. Such mergers have very little economic impact on the shareholders of the liquidated corporation and offer scant opportunity for insider trading.[12] Though the rule initially only applied to specified mergers and consolidations, in 1991 the SEC amended Rule 16b-7's title to "Mergers, Reclassifications, and Consolidations." The SEC made no mention of reclassifications in the text of the rule itself, however, creating confusion over how far the exemption truly extended.

In a 1992 no-action letter, the SEC construed Rule 16b-7 as exempting at least some types of reclassifications.[13] In connection with an impending initial public offering, Monk-Austin, Inc., a closely-held North Carolina corporation, planned to reclassify all of its outstanding shares into a new class of common stock. The rate of conversion was such that shareholders' proportionate interest in the company would be unchanged after the reclassification. The SEC agreed with Monk-Austin that the reclassification would have little economic effect on shareholders and, as such, was entitled to exemption under Rule 16b-7. Since 1992, courts have confronted cases similar to the Monk-Austin reclassification, but have approached each on an individual basis rather than adopting a per se rule exempting reclassifications as a group.[14]

Other notable exemptions to the 34 Act's profit recovery provision include (i) issuer equity securities acquired through the reinvestment of dividends or interest on securities of the same class, if made pursuant to a plan, available on the same terms to all holders of that class of securities, providing for regular reinvestment of dividends or interest; (ii) the exercise or conversion of derivative securities that were initially issued without a fixed price, and where the date the price is fixed is not known in advance and is outside the control of the recipient (the actual acquisition or disposition of derivative securities is not exempt, however); (iii) equity securities acquired through a stock split or stock dividend applying equally to all securities of that class, including a stock dividend in which equity securities of a different issuer are distributed; and (iv) equity securities disposed or acquired through the deposit or withdrawal from a voting trust or deposit agreement if substantially all of the assets held under the voting trust or deposit agreement consisted of equity securities of the same class as the security deposited or withdrawn.

'Levy. v. Sterling Holding Co.'

A Delaware federal district court recently addressed amended Rules 16b-3 and 16b-7 in *Levy v. Sterling Holding Company,*[15] the case that had previously prompted the SEC to amend both rules. In early 1997, National Semiconductor Corp. spun off Fairchild Semiconductor International, Inc. pursuant to a recapitalization plan. National retained roughly 10 million shares of Fairchild common stock, and nearly almost 12,000 shares of preferred stock. Around the same time, Sterling Holding, Co. (a Fairchild director) purchased 10 million shares of Fairchild common stock and more than 50,000 shares of its preferred stock.

In July of 1999, Fairchild stockholders voted to convert all shares of preferred stock into Class A common stock at a rate of 75 common shares for every preferred share. In exchange for their

preferred stock, Fairchild directors National and Sterling received 888,362 and 4,021,428 shares of common stock, respectively. Less than six months from the date of this conversion, both National and Sterling sold the majority of their holdings in Fairchild for a total of $72 million. Shortly thereafter, a Fairchild shareholder brought a derivative suit seeking to disgorge what he alleged were National and Sterling's short-swing profits from the sale. The district court dismissed the suit on the ground that Rule 16b-7 exempted the Fairchild stock reclassification from Section 16(b).

On appeal, the Third Circuit adopted a different view of Rule 16b-7, concluding that the title and text of the rule, taken together, left doubt as to whether the SEC intended to exempt reclassifications from Section 16(b). Instead, the court turned to a 1981 SEC interpretive release from which it concluded that Rule 16b-7 applied to some but not all reclassifications. The court stated that, logically, the same 85 percent "cross-ownership" requirement that the rule imposed on mergers and consolidations should apply to reclassifications as well. However, it rejected National and Sterling's arguments that reclassifications necessarily have 100 percent "cross-ownership" since they involve the exchange of securities of the same company. The Third Circuit argued that such a blanket approach to reclassifications was inappropriate given that some reclassifications, such as the one at issue, change shareholders' proportionate interest in the company. The court then distinguished the Fairchild reclassification from transactions pursuant to mergers typically exempted by Rule 16b-7, namely those with little to no impact on the shareholders. The court believed the Fairchild reclassification had the potential for greater shareholder impact since the non-convertible preferred shares that National and Sterling gave up carried very different risks and opportunities than the common shares they received. Owners of preferred shares often receive fixed dividends, so that the value of their investment is not subject to the same fluctuations, for better or worse, as owners of common shares. Finally, the Third Circuit noted that the reclassification of the Fairchild stock had the potential for speculative abuse, particularly in light of National and Sterling's dominance of Fairchild's board. For these reasons, the court concluded that, irrespective of Rule 16b-7's title, the SEC did not intend to exempt reclassifications like Fairchild's from Section 16(b).

The Third Circuit next considered whether Rule 16b-3 exempted the Fairchild reclassification as a transaction between the issuer and its directors, an argument that the district court had not reached. The critical inquiry was whether Rule 16b-3 required that the transaction have a compensatory purpose in order to be exempted. The rule's only explicit requirement is that the issuer's board of directors or a majority of the company's voting shareholders approve the transaction. Nonetheless, the Third Circuit found that the rule's terminology - it refers to "awards, grants, or other acquisition" - -and its focus on employee benefit plans suggested that the SEC only intended to exempt transactions with some compensatory element. The Third Circuit acknowledged that its interpretation appeared to differ from the SEC's, which stated in its 1996 release that Rule 16b-3 transactions need not "specifically have a compensatory element." The court found, however, that taken as a whole the SEC's pronouncements regarding Rule 16b-3 suggested that the rule only exempts transactions with a compensatory purpose. Because the Fairchild reclassification had no compensatory purpose, the Third Circuit held that Rule 16b-3 did not exempt it from Section 16(b) and reversed the motion to dismiss, remanding

the matter to the district court for further proceedings.

Believing that the Third Circuit misread the Rules, the SEC responded to the *Levy* appellate decision by amending Rules 16b-3 and 16b-7. The SEC inserted language into Rule 16b-3 clarifying that the exemption for transactions between an issuer and its officers or directors was not conditioned on the transaction having a compensatory purpose. It stressed that this was not a substantively new rule, only a clearer expression of the Rule's original intent. The SEC cited the 1996 release in which it rejected a compensatory-purpose requirement to demonstrate the consistency of its position.

The SEC also interpreted Levy as unjustifiably excluding from Rule 16b-7's exemption reclassifications that involve shares with different risk characteristics and reclassifications that increase insiders' proportional ownership of a company's outstanding shares. According to the SEC, these requirements were inconsistent with the rule's terms and interpretive history, as well as the Commission's intent. To prevent future confusion, the SEC inserted the term "reclassifications" into the text of the rule, along with a paragraph limiting the exemption's requirements to the 85% "cross-ownership" requirement. As with its amendments to Rule 16b-3, the SEC noted that these modifications did not represent a new position on reclassifications, but were necessary to clarify the rule's original intent.

On remand, the district court had to determine whether the SEC's amended rules were entitled to deference and whether they could be applied retroactively to the Fairchild reclassification. To determine the appropriate level of deference, the court followed the two-step test established by the Supreme Court in *Chevron U.S.A. v. Natural Resources Defense Council, Inc.*[16] First, the court found that, in granting the SEC broad authority to exempt transactions from the reach of Section 16(b), Congress intentionally left a statutory gap which it expected the SEC to fill. Second, the court found that the SEC's issuance of amended version of Rules 16b-3 and 16b-7 was a statutorily permissible way of filling that gap because the amendments were consistent with Section 16(b)'s goal of curbing insider trading. In reaching this conclusion, the court essentially adopted the SEC's arguments that transactions between an issuer and its officers and directors and transactions arising out of reclassifications do not afford opportunities for insider trading.

Although retroactive application of administrative rules generally is not favored where the rule attaches new legal consequences to events completed before its enactment, *Levy* concluded that based on the SEC's past practices and interpretive releases, the amended rules do not create new legal consequences, but rather merely clarify the SEC's consistent position on exemptions to Section 16(b). As such, the court held that the SEC's amended Rules 16b-3 and 16b-7 could both be applied retroactively and granted summary judgment in the directors' favor. Directors and officers unsure whether transactions with their employer or transactions arising out of a reclassification qualify for exemption from the short-swing profit recovery provision of Section 16(b) should take comfort from this outcome.

Endnotes:

---

[1] 475 F. Supp. 2d 463 (D. Del. 2007)

[2] 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.

[3] 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 Section16(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).

[4] 4. 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.

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

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

[7] See, Ownership Reports and Trading by Officers, Directors and Principal Security Holders, 70 Fed. Reg. 46080 (Aug. 9, 2005) (to be codified at 17 C.F.R. pts. 228, 229 & 240).

[8] See, Ownership Reports and Trading by Officers, Directors and Principal Security Holders, 60 Fed. Reg. 53832 (proposed Oct. 17, 1995).

[9] See, Ownership Reports and Trading by Officers, Directors and Principal Security Holders, 61 Fed. Reg. 30376 (June 14, 1996) (to be codified at 17 C.F.R. pts. 228, 229, 240 & 249).

[10] See, 5 Louis Loss & Joel Seligman, Securities Regulations, at 2454 (3d ed. 2001).

[11] *Tyco Intern., Ltd. v. Kozlowski*, No. MDL 02-1335-B, 2005 WL 927014 (April 21, 2005)

[12] See, Loss & Seligman, supra note x, at 2474.

[13] Monk-Austin, Inc., SEC No-Action Letter, 1992 WL 337451 (Nov. 19, 1992).

[14] See, e.g., *Rosenberg v. Harris Corp.*, No. Civ. A.01-518-SLR, 2002 WL 1496202, at *2 (D. Del. June 10, 2002).

[15] 475 F. Supp. 2d 463 (D. Del. 2007).

[16] 467 U.S. 837 (1984).