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Recent Cases Address Important Section 16 Short-Swing Issues

Federal courts in New York have in two recent cases added significantly to the law regarding several important issues arising under the short-swing trading provisions of Section 16 of the Securities Exchange Act of 1934. The issues are of particular interest to investors in convertible debt securities with fixed and floating conversion price features, traders in options, and hedge funds.

Section 16 applies to beneficial owners of more than ten percent of any class of equity security of domestic issuers registered under the Exchange Act, and directors and officers of those issuers. The provision generally requires reporting of transactions in the issuer's equity securities and disgorgement to the issuer of deemed profits resulting from purchases and sales of those securities within any six-month period. The provision is intended to provide bright-line rules that do not depend on an insider's possession of material non-public information.

In Analytical Surveys, Inc. v. Tonga Partners, L.P.,[1] the Second Circuit Court of Appeals addressed four principal issues. First, it endorsed a "bifurcated method" for analyzing short-swing profit liability in the context of so-called "hybrid derivatives" – that is, convertible securities with both fixed- and floating-price conversion features. Second, it addressed the circumstances of a limited partnership, with a general partner that is a Section 16 insider, that realizes short-swing trading profits. It concluded that the portion of those profits allocable to the limited partners in the partnership are disgorgable under Section 16. Third, it interpreted the seldom-considered "debt previously contracted" exemption, offering a narrow view of when it applies. Finally, it reiterated its support for a limited view of the scope of the Supreme Court's judicially crafted "Kern County" exception for unorthodox transactions – those that literally give rise to liability under Section 16 even though that result is not dictated by the basic policy underlying the section.

In Roth vs. Goldman Sachs Group, Inc.,[2] a district court in the Southern District of New York analyzed the treatment of a ten percent beneficial owner in connection with the expiration or cancellation of a short call option position. The court found that liability can

[1] 2012 WL 1970389 (2d Cir., June 4, 2012).

[2] 2012 WL 2006021 (S.D.N.Y., June 5, 2012).

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attach in this situation only if the defendant is a ten percent beneficial owner both when the option is written and when it expires or is cancelled.

Analytical Surveys, Inc. v. Tonga Partners, L.P.

Background

In 2003, Tonga acquired a $1.7 million promissory note (the "2003 note")[3] from ASI, a publicly-traded U.S. company. The 2003 note was convertible at any time prior to maturity at a conversion price equal to the lowest of a fixed price and two possible floating prices (each based on the company's stock price in certain periods prior to conversion). At maturity, the note would convert automatically into shares based on the conversion price at the maturity date. In May 2004, ASI defaulted on its registration rights obligations, entitling Tonga to exercise certain remedies, including acceleration, prepayment at a premium or conversion. Instead of exercising any of these remedies, Tonga negotiated with ASI in June 2004 to exchange the 2003 note for a new note (the "2004 note") with an equivalent face amount, the same conversion price formula, and a maturity date that was deferred from April 2005 to January 2006.[4] The 2004 note also eliminated mandatory conversion at maturity. In November 2004, Tonga converted the 2004 note at the applicable floating price of $1.05 per share. Over the next five days, Tonga sold in the open market at prices ranging from $3.52 to $6.62 the 1,701,341 shares it had obtained through the conversion.

Treatment of Hybrid Derivatives

Rule 16b-6(a) treats the acquisition of a fixed-price derivative security[5] that establishes a long position in the underlying stock as a purchase of the stock for Section 16 purposes. That is because the opportunity to benefit from stock price appreciation in the underlying stock arises at the time of the acquisition of the derivative. By the same logic, Rule 16a-1(c) excludes floating-price derivatives from the definition of "derivative security," so that the acquisition of a floating-price derivative is not a purchase for Section 16 purposes. The purchase does not occur until the opportunity to profit from stock price appreciation exists, usually when the derivative is exercised or the exercise price is fixed.[6]

The Second Circuit Court of Appeals first addressed the treatment of hybrid derivatives – *i.e.,* those with both a fixed- and a floating-price conversion feature – in 2006.[7]

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[3] The face amount of the note was initially $2 million. Tonga convered $300,000 of the principal in 2003.

[4] Tonga argued that what we refer to as a "new note" was instead an amendment of the old note. Substantively, at least, the court treated the instrument as a new note, as discussed in footnote 9 below.

[5] That is, generally, a security that is convertible or exercisable into an underlying security at a fixed price per share.

[6] A mirror approach applies to derivative securities that establish short positions for the holder.

[7] At Home Corp. v. Cox Communications, Inc., 446 F.3d 403 (2d Cir. 2006).

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At that time, it held that a hybrid derivative converted at a fixed price is properly treated for Section 16 purposes as though it were solely a fixed-price derivative security from the time it was acquired.

In Analytical Surveys, the court addressed for the first time the treatment of hybrid derivatives exercised at a floating price. The court noted different approaches among lower courts. One approach was to ignore the conversion at a floating price on the theory that the fixed-price feature provides an opportunity to lock in at least some profit at the time the derivative is acquired. Under this approach, the Section 16 purchase occurs at the time the derivative is acquired, and the conversion of the derivative is not a matchable transaction. An alternative approach was to treat a hybrid converted at a floating price as containing only a floating-price component, so that the purchase occurs only upon conversion. The court rejected both these approaches on the basis that they failed to consider fully the fixed and floating components of the hybrid security.

Instead, the Second Circuit adopted a bifurcated approach taken by some lower courts and endorsed by the SEC. Under this approach, the acquisition of a hybrid call-equivalent derivative is a purchase for Section 16 purposes of the number of shares that could be acquired if exercise were at the fixed price. Conversion at a lower floating price (*i.e.*, for more shares than would be acquired at the higher fixed price) is treated as a separate Section 16 purchase of the additional shares. Conversion at the fixed price would not be an additional purchase for Section 16 purposes.[8]

Accordingly, for Tonga, where the $1.7 million note had a fixed conversion price at acquisition of $2.00, and was later (together with accrued interest) converted into 1,701,341 shares, the Court of Appeals approved a lower court's finding that the *acquisition* of the 2004 note[9] involved the deemed purchase of 850,000 shares at $2.00, and *conversion* of the 2004 note involved the deemed purchase of 851,341 additional shares at $1.05, the floating

[8] An analogous approach would appear to be appropriate for a derivative security that provides for a fixed exercise or conversion price per share but relates to a variable number of shares subject to a pre-established minimum or maximum.

[9] The defense argued that the exchange of the 2004 note for the 2003 note did not involve any new opportunity for profit based on appreciation in the underlying stock and therefore should not be treated as a new deemed purchase. The court noted that the opportunity for Tonga to profit was increased because the 2004 note's longer maturity afforded more time during which profit could be realized. In addition, the court found that the elimination of the mandatory conversion feature at maturity gave Tonga more opportunity to profit because it could elect not to convert. Citing the SEC's position that an extension of an option exercise period is deemed a redemption of an existing security and the grant of a new security for Section 16 purposes, the court held that the 2004 note was materially different from the 2003 note and therefore involved the acquisition of a new security.

conversion price.[10] Both of these purchases were held matchable with the sale of the 1,701,341 shares following the conversion. Matching the lowest-priced purchases with the highest-priced sales, the court calculated a profit of nearly $5 million.

We note that although the bifurcated approach adopted by the court accounts for both moments at which the insider acquires the opportunity to benefit from stock price appreciation in the underlying, its calculation methodology does not necessarily account for all the profits an insider might receive. Suppose, for example, that an insider purchases at par a convertible note with a face amount of $100. The note can be converted at the lower of $10 per share, the prevailing market price of the underlying at the time the note is acquired, or the prevailing market price of the underlying at the time of conversion. Three months later, the insider converts the note at market price, then $5 per share, and receives 20 shares. A week after conversion, the insider sells the shares at market price, which is then $20 per share, and receives $400. Under the bifurcated approach, there would be two purchases with which to match the insider's sale: (i) a purchase of 10 shares at $10 in connection with the initial acquisition of the hybrid derivative and (ii) an additional purchase of 10 shares at $5. The sale of 20 shares at $20 for proceeds of $400 would be matched against the $150 purchase price calculated under the bifurcated method, for a disgorgable profit of $250. However, the insider paid $100 for the derivative, so that he realized an actual cash profit of $300. In effect, the disgorgable profit is reduced by $50 because the insider's potential for profit on 10 shares was locked in at the time the convertible note was acquired, even though the actual conversion occurred at the lower $5 price for those 10 shares.[11]

Limited Partnership Liability

The court in Analytical Surveys also addressed an exculpatory position under Section 16 that is relevant in the context of hedge funds and other investment partnerships, and reiterated its rejection of that position.[12] Basically, the position is that when such a partnership realizes profits through short-swing trades, only the portion of the profits allocable to the ultimate controlling person of the partnership is required to be disgorged

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[10] We note that neither the court of appeals nor the lower court referred to Rule 16b-6(c) in connection with the profit determination. Rule 16b-6(c) provides, generally, that when a transaction in a derivative is matched with a transaction in the underlying, the amount of profit shall not exceed the difference in the price of the underlying on the date of the purchase and sale. It appears from ASI's SEC filings that the market price of the ASI stock underlying the 2004 note on June 30, 2004, and November 10, 2004, the dates of the deemed matchable purchases, was in excess of $2.00 and $1.05, respectively. Accordingly, it seems as though an argument could have been made for limiting the disgorgable profit on the basis of Rule 16b-6(c)'s limitation.

[11] In Analytical Surveys Tonga acquired the portion of the note at issue for $1.7 million, and the aggregate proceeds from its sale of stock in 2004 was approximately $8.2 million, but the disgorgable profit was approximately $5 million.

[12] The court also recently rejected the position in Huppe v. WPCS Int'l Inc., 670 F.3d 214 (2d Cir. 2012).

under Section 16, leaving the investment partnership itself, and therefore the passive investors in the investment partnership, unaffected and able to retain the short-swing trading profits realized by virtue of the trading decisions of the controlling insider. The analysis that justifies this result is based on the argument that when a partnership acquires a more than 10% interest in stock of a public company, the Section 16 insider is the ultimate controlling person of the partnership (typically, the person who controls a limited partnership's general partner), since only that person has Section 13(d) beneficial ownership over the partnership's securities (*i.e.*, voting or dispositive power), and Section 13(d) beneficial ownership is required for insider status. In addition, the position is based on the fact that the definition of "beneficial ownership" for purposes of profit disgorgement takes a look-through approach to determining the pecuniary interest of partners in a partnership and thereby can be read to ignore the pecuniary interest that a partnership (as a separate entity) has in securities held by it (as contrasted with the interests of the partners in those securities). The court found this argument to be creative but contrary to basic agency law and inconsistent with the purpose of Section 16. The court's conclusion that the limited partnership itself is subject to Section 16 liability can be justified, notwithstanding any ambiguity in the rules, on the basis that the general partner's exercise of voting and investment power in that context is as an agent on behalf of the limited partnership, which should therefore be considered itself to be an insider.

Debt Previously Contracted Exemption

Section 16(b) exempts from liability any profit realized from short-swing trades involving a security "acquired in good faith in connection with a debt previously contracted." The defense in Analytical Surveys argued that this infrequently-used exemption applied because Tonga, the insider, acquired the 2004 note in satisfaction of the debt ASI owed to Tonga following ASI's default on the 2003 note.

The court drew on the few existing precedents interpreting the debt previously contracted exemption in rejecting Tonga's argument. The court agreed with other circuits that the debt at issue must constitute "an obligation to pay a fixed sum certainly and at all events"[13] and a "matured debt which existed apart from any existing obligation to transfer the securities."[14] The court considered New York state law, as the governing law of the 2003 note, for the meaning of "matured," finding that because Tonga did not accelerate the 2003 note the 2003 note did not mature, and Tonga could therefore not rely on the exemption.

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[13] Rheem Mfg. Co v. Rheem, 295 F.2d 473 (9th Cir. 1961) (internal quotations omitted).

[14] Heli-Coil Corp. v. Webster 352 F.2d 156 (3d Cir. 1965) (internal quotations omitted).

The court indicated that it therefore did not need to consider whether the debt was independent of ASI's existing obligation to transfer stock to Tonga, as well as whether, if the exception were to apply, the shares obtained from converting the 2004 note also would be securities eligible for the exception.

It seems clear in light of the court's decision that the debt previously contracted exemption will continue to be construed narrowly and rarely helpful. Insiders should be very cautious in planning transactions in reliance on the exemption. It would appear that only an obligation that has been accelerated or reached its stated maturity is eligible for the exemption and only if that obligation does not, by its terms, involve an obligation to transfer securities. For example, profits arising from transactions including an acquisition of stock in settlement of a loan secured by stock may well not qualify for the exemption.

Borderline/Unorthodox Transaction Exception

In Kern County v. Occidental Petroleum Corp., the Supreme Court recognized a limited exception from the requirements of Section 16 for transactions that do not "serve as a vehicle for the evil which Congress sought to prevent – the realization of short-swing profits based upon access to inside information."[15] The Second Circuit has interpreted this exception narrowly, requiring "an involuntary transaction by an insider having no access to information."[16]

In Analytical Surveys the defense argued that because the acquisition of the 2004 note resulted from direct negotiations with ASI, ASI and its board had equal access to information, and the transaction had board approval, there was no possibility of Tonga gaining any speculative advantage through purchases and sales within six months. The defense argued that this equality of information should exempt Tonga from any disgorgement obligation, under the Kern County doctrine.

The court did not accept this defense argument either, citing its recent precedent specifically rejecting the argument that the Kern County exception should apply to a transaction merely because it was the product of direct negotiations between the company and the insider and approved by the board.[17] The court also emphasized that where there is at least the possibility of speculative abuse of inside information, then Section 16(b) applies. The court contrasted its views on the Tonga trade with trades falling within Rule 16b-3, which exempts from Section 16(b) certain transactions between a company and its directors or officers that are approved by the company's shareholders, board of directors or compensation committee. In exercising its rulemaking authority the SEC stated that it viewed Rule 16b-3 as appropriate because the transactions exempted by it have a

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[15] 411 U.S. 582 (1973).

[16] At Home, at 403.

[17] Huppe, at 214.

substantially diminished risk of speculative abuse; the court in Analytical Surveys stated that this policy judgment should not be imported from the context of a specific SEC rule to broaden the narrow, judicially-crafted Kern County exception.

Roth v. Goldman Sachs Group, Inc.

In Roth, the Southern District of New York dismissed a claim against Goldman in connection with its writing of fixed-price call options while it was a ten percent beneficial owner of Leap Wireless. Shortly after writing the options, Goldman reduced its ownership in the company below ten percent, and the options expired unexercised several months later. The decision turned on the application of Rule 16b-6:

- ***Writing the Option.*** Writing a fixed-price call option is defined as a "put equivalent position" under Rule 16a-1(h), and Rule 16b-6(a) provides that establishing a put equivalent position is deemed a sale of the underlying securities for Section 16(b) purposes. (The value of a short call position increases as the underlying stock price decreases because the likelihood of the buyer exercising the option decreases and the writer's chance of keeping the premium from writing the option increases.)

- ***Exercise or Conversion of the Option.*** The closing of a derivative security position as a result of its exercise or conversion, as well as the disposition of underlying securities at a fixed exercise price due to the exercise of a put equivalent position, are exempt from Section 16(b) under 16b-6(b).

- ***Cancellation or Expiration of the Option.*** Rule 16b-6(d) provides that upon the closing of a put equivalent position as a result of its cancellation or expiration within six months of the option being written, any profit derived from writing the option is recoverable under Section 16(b). The profit is limited to the premium received by the writer. Rule 16b-6(d) does not clearly state what are the specific purchase and sale transactions that give rise to the disgorgement liability for the premium.

Goldman was not an insider at the time the call options expired, and therefore argued that it could not be held liable under Section 16(b), which imposes liability on a ten percent beneficial owner only if it has that status both at the time of the relevant purchase and sale. Goldman also argued the expiration of the options was not a purchase for Section 16 purposes. Although the first argument was Goldman's primary position and the basis for the court's ruling, the court addressed the second argument at some length, reflecting sympathy for the plaintiff's position.

Goldman's second argument drew on the Second Circuit Court of Appeals' holding in Allaire Corp. v. Okumus.[18] In that case, the defendant wrote call options and became a

[18] 433 F.3d 248 (2d Cir. 2006).

ten percent beneficial owner three days later. The options expired unexercised approximately one month after being written and a month after that the defendant, while still an insider, wrote additional call options. The plaintiff argued that under Rule 16b-6(a) the expiration of the first set of call options was a purchase matchable against a sale arising from the writing of the second set of call options. The Court of Appeals acknowledged that the plaintiff's reading of the rule was not implausible. Observing, however, that the exercise of a fixed-price option is a non-event for Section 16(b) purposes because it involves no opportunity for abuse of inside information, the court held that an insider writing a fixed-price option should not be worse off if the option expires unexercised. The court found, therefore, at least in that context, that the expiration of the first set of call options could not be matched with the writing of the second set of call options to create liability. A broad reading of Allaire would have, therefore, helped Goldman.

In Roth, however, the court found that, absent some limitation, the holding in Allaire would undermine Rule 16b-6(d), which requires only the writing of an option and its expiration to impose liability. The court therefore concluded that Allaire should be read as interpreting only Rule 16b-6(a) – *i.e.,* just as the exercise of a fixed-price call option is not a sale by the writer under that section, its expiration also is not a sale *for purposes of that section, and that section only*. The court noted that Rule 16b-6(d) makes sense only if the expiration of an option can serve as a purchase to match the sale that takes place when the option is written.

Against this persuasive logic, the plaintiff creatively argued that the writing of the short call options by Goldman was in and of itself both the relevant purchase and sale because this afforded the opportunity for the abuse of inside information against which Section 16(b) is aimed. The court expressed sympathy for this position from a policy perspective, but ultimately rejected it as inconsistent with the requirement of Section 16 that there be a separate purchase and sale in order for liability to arise, noting that the plaintiff was unable to adduce any precedent finding that a single transaction could comprise both. Accordingly, under Roth, a ten percent beneficial owner writing a fixed-price call option can be subject to liability under Rule 16b-6(d) only if the writer is a ten percent beneficial owner at both the time the option is written and its expiration. As described above, in the circumstances of Roth Goldman was only a ten percent shareholder at the time it wrote the call options, and therefore was not subject to disgorgement liability. Notwithstanding the court's seeming reluctance to reach that result, it seems most consistent with the

longstanding interpretation that a ten percent shareholder must be such at the time of both a purchase and a sale in order to incur disgorgement liability under Section 16.

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If you have any questions, please feel free to contact any of your regular contacts at the firm or any of our partners and counsel listed under "Corporate Governance" or "Executive Compensation and ERISA" under the "Practices" section of our website at http://www.clearygottlieb.com.

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