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SECOND CIRCUIT REVIEW

Expert Analysis

Court Construes Short-Swing Profit Rule

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This month, we discuss *Gibbons v. Malone*,[1] in which the U.S. Court of Appeals for the Second Circuit considered a novel application of the "short-swing profit rule" of Section 16(b) of the Securities Exchange Act of 1934 (Exchange Act). The court's opinion, written by Judge José Cabranes and joined by Judge Pierre Leval and Judge Robert Katzmann, addressed for the first time whether the short-swing profit rule applies to a corporate insider's purchases and sales of different types of securities in the same company. Affirming the district court, the court held that such transactions would not trigger Section 16(b) liability "where those securities are separately traded, non-convertible, and come with different voting rights."[2]

Background

Over the course of 13 days in December 2008, defendant John C. Malone, a director and major shareholder of Discovery Communications Inc., made 10 purchases of Discovery's Series A stock and nine sales of Discovery's Series C stock. As a result of these transactions, Malone earned a profit of $313,573.

Although both series of common stock were equity securities of Discovery, traded on the NASDAQ, and were registered under Section 12 of the Exchange Act, they also differed in several crucial respects. For example, pursuant to Discovery's Articles of Incorporation, Discovery's Series A stock carried voting rights of one vote per share, while holders of Series C stock lacked a right to vote. Series A stockholders were eligible to receive share distributions of Series C stock, but Series C stockholders could not receive distributions of Series A stock. And while an options market existed for Series A stock, no such market was available for Series C stock. Importantly, the stocks were not convertible.

> 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, of any equity security of such issuer…within any period of less than six months…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….[3]

An "equity security" is defined by the statute as "any stock or similar security; or any security future on any such security; or any security convertible…into such a security, or carrying any warrant or right to subscribe to or purchase such a security…."[4]

As the Supreme Court and Second Circuit have explained, the short-swing profit rule provides a "prophylactic" tool to curb insider trading where two sets of transactions within a six-month period can be "paired," indicating a threat that inside information can be used to obtain specu-

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lative profits.[5] The statute does not require a showing of intent, because to do so would hinder the mechanical application of the rule. Although courts have long understood that the paired transactions need not involve the same particular shares or certificates of stock, they traditionally have limited Section 16(b) to transactions in the same type of stock issued by a single company.

Given that history, the Discovery board declined to take action, taking the position that the transactions at issue did not fall within the scope of Section 16(b). Having been substituted as the named shareholder plaintiff, Michael Gibbons then filed a derivative action in the Southern District of New York to recover Malone's allegedly illicit short-swing profits on behalf of Discovery.

The District Court Case

Considering defendants' motion to dismiss the complaint, the district court addressed plaintiff's "apparently novel theory of liability under Section 16(b)" that sales of one series of a company's equity securities and purchases of a different series of the company's equity securities could be paired as a prohibited short-swing transaction.[6] The district court rejected plaintiff's reading of the statute. The district court determined that a plain reading of the statute's mandate regarding "the purchase and sale, or sale and purchase, of any equity security"—with each transaction directed to the same object and the singular use of the term "security"—required that the same type of security be present in both the purchase and the sale. The district court also rejected plaintiff's argument that the placement of "any" before "equity security" instructed otherwise. Rather, such language reflected only that any type of security can give rise to liability under Section 16(b), so long as it is the subject of both the purchase and sale.

Next, the district court distinguished the securities involved from the types of convertible derivatives held to be within the scope of Section 16(b) in other cases. Unlike in *Chemical Fund v. Xerox*,[7] for example, where the Second Circuit held that derivatives and the underlying common stock to which they relate should be considered the same class of equity security under Section 16(b), plaintiff here did not allege that the securities at issue were derivatives.

> The opinion addressed for the first time whether the short-swing profit rule applies to a corporate insider's purchases and sales of different types of securities in the same company.

Noting the SEC's guidance that securities without a fixed exercise price are not derivatives for Section 16(b) purposes because they do not provide the same opportunity to guarantee a short-swing profit, the district court rejected plaintiff's assertion that the "highly correlated" prices of the Series A and Series C stocks at issue were sufficiently similar to render their prices "fixed" under the SEC's formulation. Plaintiff's reliance on *Gund v. First Florida Banks*,[8] an Eleventh Circuit decision, was similarly unavailing. Unlike in *Gund*, where the U.S. Court of Appeals for the Eleventh Circuit found that transactions in convertible subordinated debentures and the common stock into which they converted were covered by Section 16(b), the series of securities at issue in this case were not convertible and thus easily distinguishable.

Finally, the district court declined to accept plaintiff's alternative argument that the stocks at issue were merely two different series of the same class of common stock and thus subject to Section 16(b). Given their differences in voting rights and dividend preferences, as well as their lack of convertibility and the fact they were subject to varying options markets, the district court concluded that the Series A and Series C stocks constituted different classes of equity securities. Nor would plaintiff's policy arguments yield a different outcome: Noting the Supreme Court's reference to the "arbitrary nature of section 16(b)" and the easily applied, mechanical rule intended by Congress, the district court acknowledged the risk of evasion that its decision might create but declined to adopt a different position.[9] Accordingly, the district court granted defendants' motion to dismiss.

The Second Circuit's Decision

On appeal, the Second Circuit began by considering the text of Section 16(b). Like the district court, the court found the singular use of "any equity security" to support defendants' position that the transactions must involve the same type of security to be covered by the statute. The court found further support for this reading in SEC regulations and the court's own "longstanding view that although §16(b) '*might* be read literally to permit a recovery where stock of one class is purchased and stock of another class sold,' the likelihood 'that Congress intended such a result is beyond the realm of judicial fantasy.'"[10]

Next, the court considered plaintiff's argument that the short-swing profit rule should apply because Discovery's Series A and Series C stocks were "economically equivalent" and thus "the same security" for purposes of Section 16(b).[11] Like the district court, however, the Second Circuit emphasized the importance of "fixed-ratio convertibility" in distinguishing the Discovery securities. The court observed that "economic equivalence has no relevance in a situation where the convertible security did not trade at a price at least equivalent to the aggregate price of the securities into which it was convertible,"[12] and echoed the SEC's position that Section 16(b) equity securities do not include derivatives without a fixed exercise price. Because the stocks traded here were not convertible and varied in price relative to each other, they could not be considered economic equivalents capable of conferring Section 16(b) liability.

Nor would the court accept plaintiff's contention that the securities were sufficiently "similar" to give rise to liability under the short-swing profit rule. To do so, the court explained, would turn Section 16(b) into a mere "standard" when Congress had created the provision to establish a clear and binding rule that could be applied simply, consistently, and mechanically across all situations. A rule of application that depended upon similarity would run afoul of these principles and thus could not be adopted.

Unlike the district court, however, the Second Circuit acknowledged the possibility that the short-swing profit rule could apply to transactions outside of the narrow parameters set forth in its opinion. Indeed, the court suggested that Section 16(b) might cover transactions "where the securities at issue are not meaningfully distinguishable," and "acknowledge[d] the plausibility" of plaintiff's argument that similarity alone might be sufficient to establish liability.[13] With respect to the latter possibility, the court qualified its rejection of plaintiff's argument, stating that the court would not adopt plaintiff's position on similarity "absent SEC direction."[14] The court almost seemed to invite a Securities and Exchange Commission opinion to the contrary, noting the unknown "effect future SEC guidance might have on the conclusions that we reach today."[15]

Unlike the district court, the Second Circuit acknowledged the possibility that the short-swing profit rule could apply to transactions outside of the narrow parameters set forth in its opinion.

The court's holding also emphasized the specific facts of the case, stating that Section 16(b) liability would not attach "where [the] securities are separately traded, nonconvertible, and come with different voting rights."[16] Such comments suggest that while the Second Circuit may have purported to announce a straightforward, strict textual application rule in keeping with the statute's historically blunt application, the court may have left the door slightly ajar to the possibility of a more flexible approach to interpreting the short-swing profit rule.

Conclusion

The Second Circuit's decision in *Gibbons* clarifies the scope of Section 16(b) of the Exchange Act, holding that the short-swing profit rule does not apply to transactions in different types of securities issued by the same company that are not convertible and have different voting rights. But the court stopped short of holding that transactions in different types of securities can never give rise to Section 16(b) liability. Rather, the court's commentary regarding possible extension of the rule to scenarios where the securities in question are similar but not identical indicates a potential willingness to revisit the question on another day, should the facts allow and should the SEC provide relevant guidance.

1. Docket No. 11-3620-cv, 2013 WL 57844 (2d Cir. Jan. 7, 2013).
2. Id. at *7.
3. 15 U.S.C. §78p(b).
4. 15 U.S.C. §78c(a)(11).
5. 2013 WL 57844, at *3 (quoting *Blau v. Lehman*, 368 U.S. 403, 414 (1962)).
6. 801 F.Supp.2d 243, 246 (S.D.N.Y. 2011) (Jones, J.).
7. 377 F.2d 107 (2d Cir. 1967).
8. 726 F.2d 682 (11th Cir. 1984).
9. 801 F.Supp.2d at 249 (quotations and citations omitted).
10. 2013 WL 57844, at *4 (quoting *Smolowe v. Delendo Corp.*, 136 F.2d 231, 237 n.13 (2d Cir. 1943) (emphasis added by *Gibbons*).
11. 2013 WL 57844, at *4.
12. Id. at *5 (quoting *Blau v. Lamb*, 363 F.2d 507, 524–25 (2d Cir. 1966)).
13. 2013 WL 57844, at *4, *5.
14. Id. at *5.
15. Id. at *5 n.8.
16. Id. at *7.