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SECOND CIRCUIT REVIEW

Expert Analysis

Court Adopts Bifurcated Approach To Treatment of Hybrid Securities

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This month, we discuss *Analytical Surveys v. Tonga Partners*,[1] in which the U.S. Court of Appeals for the Second Circuit affirmed the district court's finding of liability for short-swing insider trading. The court's opinion, written by Judge Debra Livingston and joined by Judges Peter Hall and Denny Chin,[2] considered whether a statutory insider's exercise of an option on a hybrid convertible security at a floating price constituted a "purchase" under Section 16(b) of the Securities Exchange Act and whether the "debt" or "borderline transaction" exceptions applied.

Background

In April 2002, Tonga Partners invested $2 billion in ASI, a digital mapping service, by acquiring a senior secured convertible promissory note (the 2002 note). Under the note's terms, Tonga could, at any time prior to the maturity date, convert it into shares of ASI common stock, the quantity of which would be determined by a formula related to the then-current price per share. Under that formula, the conversion price per share would be the lesser of a fixed price or two possible floating prices that were linked to ASI's average stock price during certain periods prior to conversion. Upon maturity, on April 2, 2005, the 2002 note would convert automatically into shares.

At the same time, Tonga and ASI entered into a Registration Rights Agreement by which ASI agreed, within a certain period of time, to file a registration with the Securities and Exchange Commission for the shares acquirable by conversion of the 2002 note and, within 150 days of registration, to have that statement declared effective.

The deadlines under the agreement were eventually extended to December 2003 and May 2004, respectively. Under the agreement, failure to timely file a registration statement and have it declared effective would constitute default. Upon default, Tonga would have several options, including immediate conversion of the note into shares, payment in cash, and continuing to hold the note to maturity.

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In October, 2003, Tonga converted $300,000 of the 2002 note into shares of ASI common stock. ASI then issued an amended note for $1.7 million on the same terms as the 2002 note (the 2003 note).

ASI timely filed the registration statement, but the declaration of effectiveness failed to issue within 150 days, leaving ASI in default. Instead of demanding the outstanding balance of the note in cash—which would have driven ASI into bankruptcy—in June 2004, the parties negotiated a new $1.7 million note with a maturity date of Jan. 2, 2006 (the 2004 note). Under the terms of the 2004 note, the note would no longer convert automatically upon reaching maturity; instead, Tonga had the option to convert the principal balance into shares or to insist on payment in full in cash.

> This decision resolves disagreement within the district courts about the proper treatment of hybrid securities under the Exchange Act.

On Nov. 10, 2004, Tonga converted the outstanding principal of the 2004 note into shares of ASI common stock at the floating price of $1.05 per share. Over the next five days, Tonga sold all the shares acquired on the 2004 note in the open market at prices ranging from $3.52 to $6.62 per share.

On April 2, 2006, ASI filed an action in the U.S. District Court for the Southern District of New York, seeking disgorgement under Section 16(b) of the Exchange Act of the profits earned by Tonga on its November 2004 sales of ASI shares. On opposing motions for summary judgment, the district court denied Tonga's motion in its entirety, granted summary judgment in part to ASI, and ordered Tonga to disgorge $4,965,898.95 in profits. The district court denied Tonga's motion for reconsideration. Tonga appealed.

The 'Debt' Exception

Section 16(b) of the Exchange Act[3] requires statutory insiders—those who have an ownership interest greater than 10 percent in an equity security—to disgorge all profits realized from short-swing trading, which is defined as a purchase and sale, or sale and purchase, of the same security within a six-month period. Section 16(b) "operates mechanically" and makes no distinction between "technical violators of pure heart, and…corrupt insiders who skirt the letter of the prohibition."[4] The Exchange Act excepts only limited transactions defined as "debt" or "borderline transactions."

The debt exception excuses from §16(b) liability a security that "was acquired in good faith in connection with a debt previously contracted."[5] Tonga argued that this exception applied because it acquired the 2004 note from ASI in satisfaction of the debt ASI owed as a result of its default on the 2003 note.

The panel disagreed. First, the panel noted that a transaction can only fall under the debt exception where it is "an obligation to pay a fixed sum certainly and at all events,"[6] which would only be true if the 2003 note had reached maturity. ASI issued the 2004 note in June 2004, but the 2003 note would not reach maturity until April 2005. Tonga argued that, by virtue of ASI's default in May 2004, the 2003 note reached maturity early.[7] Although, in the event of default, it is possible to require acceleration of a debt such that a note matures early, the panel held that the terms of the 2003 note did not require acceleration upon default, but rather allowed acceleration as one of several options.

Because acceleration was not mandatory, the 2003 note maintained its preexisting maturity date until Tonga demanded payment or immediate conversion. Because Tonga never made such a demand, the 2003 note's maturity date remained April 2, 2005, and the note had not reached matu-

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rity as of June 2004. Therefore, there was no "obligation to pay a fixed sum" at that point.

As an additional basis for its decision, the panel looked to the plain language of the 2003 note, which distinguished between events of default upon which the debt would become "automatically due and payable" and others upon which the debt would be accelerated and payable only at the option of the noteholder. Tonga's interpretation would render this distinction meaningless. So for this additional reason, the panel held that the note was not matured absent a demand by Tonga for acceleration and that, therefore, the acquisition of the 2004 note did not fall under the debt exception.

'Borderline Transaction'

Under the U.S. Supreme Court's decision in *Kern County Land v. Occidental Petroleum*, the borderline transaction exception excuses from §16(b) liability 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."[8] The Second Circuit in *Huppe v. WPCS International* has held that this exception applies only where: (1) the transaction is involuntary and (2) the insider has no access to inside information.[9]

Tonga did not argue that it lacked access to inside information (and the panel did not consider whether the transaction was involuntary), but rather, that *Kern County* is not limited as the Second Circuit has interpreted it. Tonga argued that even assuming it had inside information, it was impossible for it to gain any advantage from that information because its acquisition of the 2004 note was the product of negotiations directly with ASI, and because there was no information asymmetry between Tonga and ASI's board, which had approved the transaction.

The panel disagreed in light of its recent holding in *Huppe*, in which it rejected the argument that a transaction qualifies for the borderline transaction exception merely because a company's board approved a transaction with an insider after direct negotiations.[10] The panel reaffirmed that where an insider has access to inside information, that alone means that it cannot benefit from the borderline transaction exception.

Hybrid Securities 'Purchases'

Next, the panel addressed the question whether Tonga's acquisition of the 2004 note and its later conversion of that note into common stock constituted "purchases" for the purpose of §16(b) liability. As the first step of this analysis, the panel considered whether the 2004 note was new or amended, as ASI conceded that the acquisition of an amended note could not be a "purchase." In making this inquiry, the panel had to consider whether the differences between the 2003 and 2004 notes were sufficiently material that the 2004 note should be considered a newly issued security.

The panel held that the 2004 note was a new security. Under an SEC release to which it owed *Chevron* deference (*Chevron, U.S.A. v. Natural Resources Defense Council*, 467 U.S. 837 (1984)) because the 2003 and 2004 notes had different maturity dates, Tonga's acquisition of the 2004 note constituted redemption of the 2003 note and a grant of a new security.[11]

Despite deciding the issue as a matter of law, the panel also addressed Tonga's argument that it should conduct a fact-intensive analysis into the note's specific features. Among the differences between the two notes were the extended maturity date and the elimination of the provision that required mandatory conversion of the note when it reached maturity. Tonga argued that the 2004 note's later maturity date was not material because Tonga could have gained no advantage from its access to inside information at the time the note issued.

The panel noted, however, that the proper inquiry was not whether the changed terms provided for a greater opportunity for short-swing trading merely at acquisition, but also at any other time prior to maturity. By extending the maturity date relative to the 2003 note, Tonga benefitted from an additional nine months during which it could use inside information; in light of the elimination of the mandatory conversion provision, it could even wait until the maturity date to decide whether to convert the note into shares or demand cash payment. Thus, even under Tonga's fact-based approach, the panel determined that the 2004 note was materially different from the 2003 note, such that it constituted a newly issued security.

As the second step in its analysis, the panel considered the effect of the note's "hybrid" nature. For §16(b) purposes, acquisition of a derivative security that gives the holder the option to convert at a fixed price is treated the same as an outright purchase of the security. Thus, the acquisition and not the exercise is the "purchase." The logic behind this rule is that the insider's use of inside information is beneficial primarily at the outset when it makes its bet on the future performance of the stock and the price is set.

Under §16(a), however, a convertible security with a floating price is excluded from the definition of "derivative security." Thus, prior to conversion, a convertible security with a floating exercise price is not subject to §16(b)'s proscription.

For hybrid convertibles—those with both fixed and floating option prices—like the one at issue in this case, the inquiry is more complicated. Where a hybrid is converted at a fixed price, the Second Circuit has held that it should be treated as though it were exclusively a fixed-price option, such that the acquisition is the relevant "purchase" for the purposes of §16(b)'s six-month clock.[12] But the Second Circuit had never decided what course to follow where a hybrid is converted at a floating price, and the district courts in the circuit had taken various approaches.

Under *Lerner v. Millenco* and *Levy v. Oz Master Fund*, the U.S. District Court for the Southern District of New York held that a hybrid converted at a floating price should be treated as though it were a fixed-price security because "where there is a hybrid conversion privilege…the fixed price has enabled the investor who has received inside information to lock [in] his position with a minimum number of shares, and, thereby, realize a minimum profit."[13]

The panel disagreed with the *Lerner/Oz* approach because it failed to recognize the additional opportunity to rely on inside information to strategically select the conversion date to maximize the number of shares obtained above the locked-in minimum. The panel instead adopted the approach taken by the lower court in this case.[14] Under this "bifurcated" approach, where a hybrid convertible is converted at the fixed price, only the acquisition counts as a purchase for §16(b) purposes, just as though it were a derivative with only a fixed-price option. But where it is converted at a lower, floating price, the initial acquisition still counts as a §16(b) purchase, but the conversion counts as another §16(b) purchase with respect to the additional shares over those that could have been purchased at the fixed price.[15]

Conclusion

The Second Circuit's decision in *Analytical Securities*—and its recent decision in *Huppe*—provides some helpful clarifications regarding the debt and borderline transaction exceptions to §16(b)'s prohibition of short-swing insider trading. But more importantly, this decision resolves disagreement within the district courts about the proper treatment of hybrid securities under the Exchange Act.

Interestingly, although §16(b) does not distinguish between "corrupt insiders" and "technical violators of pure heart," this decision has very different implications for these two categories of investors. Under *Analytical Surveys*, corrupt insiders will be able to more confidently skirt the six-month rule for hybrid securities exercised at a fixed price, and those of pure heart will be able to conscientiously avoid short-swing trading when exercising hybrid options at a floating price. In either event, this resolution will allow statutory insiders to make more efficient decisions regarding when to convert hybrid securities.

1. Docket No. 09-2622-cv, 2012 WL 1970389 (2d Cir. June 4, 2012).
2. At the time of the argument, Chin was a U.S. District Judge for the Southern District of New York, sitting by designation.
3. 15 U.S.C. §78p(b).
4. *Magma Power v. Dow Chem*, 136 F.3d 316, 320-21 (2d Cir. 1998).
5. Id.
6. *Rheem Mfg. v. Rheem*, 295 F.2d 473, 476 (9th Cir. 1961).
7. Because the Note specified that it was to be construed under New York state law, and because there was insufficient guidance in §16(b) itself and in the debt exception precedents, the panel applied New York state law to the question of whether the Note had reached maturity as of June 2004.
8. 511 U.S. 582, 593-94 n.26 (1973) (internal quotation marks omitted).
9. *Huppe v. WPCS Int'l*, 670 F.3d 214, 218-19 (2d Cir. 2012); *At Home v. Cox Commc'ns*, 446 F.3d 403, 408 (2d Cir. 2006).
10. 670 F.3d at 220. The panel's decision in *Analytical Surveys* was significantly delayed as it awaited the *Huppe* decision.
11. See *Gryl v. Shire Pharm. Grp.*, 298 F.3d 136, 145 n.8 (2d Cir. 2002) (citing Ownership Reports and Trading by Officers, Directors and Principal Security Holders, Exchange Act Release No. 29,131, 1991 WL 292345, at *4 n.35 (April 26, 1991) (citations omitted)). Although this release dealt with options, Tonga did not provide any reason why the conclusion should differ for a convertible note.
12. *At Home*, 446 F.3d at 405-08.
13. *Levy v. Oz Master Fund*, No. 00-7148, 2001 WL 767013, at *7 (S.D.N.Y. July 9, 2001); see also *Lerner v. Millenco*, 23 F. Supp. 2d 337 (S.D.N.Y. 1998).
14. See *Analytical Surveys v. Tonga Partners*, No. 06 Civ. 2692(KMW)(RLE), 2008 WL 4443828 (S.D.N.Y. Sept. 29, 2008); see also *Schaffer v. CC Invs.*, 280 F. Supp. 2d 128 (S.D.N.Y. 2003); *At Home*, 446 F.3d 403.
15. Tonga would have violated §16(b) even under the *Lerner/Oz* approach, but the panel's decision affected the amount of profits it had to disgorge.

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